IT 16-02
Tax Type: Income Tax
Tax Issue: Claim Issues – Right To Refund

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

THE DEPARTMENT OF REVENUE OF THE STATE OF ILLINOIS	
v.	**Docket # XXXX** **Acct ID: XXXX** **Letter ID: XXXX**
JOHN AND JANE DOE	**Letter ID: XXXX**
Taxpayers	**Reporting Periods: 12/09, 12/10**

RECOMMENDATION FOR DISPOSITION

Appearances: Ralph Bassett, Special Assistant Attorney General, for the Department of Revenue of the State of Illinois; Joseph Demko of Smith Amundsen, LLC for John and Jane Doe.

Synopsis:

John and Jane Doe ("taxpayers") are residents of the State of Illinois. For the years 2009 and 2010, after filing their original returns, the taxpayers filed amended Illinois income tax returns, Forms IL-1040-X, to claim a credit for taxes paid to the State of New York. The Department of Revenue ("Department") issued two Notices of Claim Denial ("Notices") to the taxpayers pursuant to section 601(b)(3) of the Illinois Income Tax Act ("Act") (35 ILCS 5/101 *et seq.*) on the basis that the taxpayers did not provide documentation substantiating the fact that the income earned by John Doe while he was in New York was not Illinois income. The Department contends that Illinois is John Doe's "base of operations," and the income is Illinois income, not New York income. The taxpayers contend that denying them credit for taxes paid to another state violates the Commerce Clause of the U.S. Constitution. The taxpayers timely protested the

Notices and an evidentiary hearing was held by administrative law judge Ken Galvin.[1] After reviewing the evidence and the briefs filed by the parties, it is recommended that this matter be resolved in favor of the Department.

FINDINGS OF FACT:

1. During 2009 and 2010, the taxpayers were residents of the State of Illinois. (Dept. Ex. #2, 4; Tr. p. 14)
2. During 2009 and 2010, John Doe was employed by ABC Business ("ABC Business"), which is headquartered in New Jersey. (Tr. p. 14)
3. During 2009 and 2010, as part of his employment with ABC Business, John Doe worked part of each year in New York City. The manager at ABC Business's New York City office reported directly to John Doe, and all of the employees in that office were directly in John Doe's line of management. John Doe's supervisor was based at ABC Business's headquarters in New Jersey. (Tr. pp. 12-15)
4. The New York State Department of Taxation and Finance conducted an audit of the taxpayers' income for the years 2009 and 2010.[2] The audit determined that John Doe worked in New York for 8 days in 2009 and 12 days in 2010 and assessed tax due to New York for those years.[3] (Taxpayer Ex. A; Tr. p. 12)
5. The taxpayers filed amended Illinois income tax returns, Forms IL-1040-X, for the years 2009 and 2010 in which they requested a credit for taxes paid to the State of New York for those years. (Dept. Ex. #2, 4)

[1] This recommendation has been written by the undersigned, ALJ Linda Olivero. It is not a requirement that the ALJ who heard and took the evidence be the one to make the recommendation. American Welding Supply Co. v. Department of Revenue, 106 Ill. App. 3d 93, 98-99 (5th Dist. 1982). The facts in this case are not in dispute, and credibility is not an issue.

[2] The audit included the year 2008, which is not at issue in this case.

[3] Although it was not specifically cited by the parties, New York law apparently requires a portion of the income to be taxed.

6. The taxpayers' amended returns included Schedule CR, Credit for Tax Paid to Other States. The instructions for Schedule CR include the following for Line 1, Wages, salaries, tips, etc.:

> Write the amount of wages not shown as Illinois wages on the state copy of the W-2 forms you received. **Do not include** wages taxed by another state if they are also shown as Illinois wages. … **Note**: If the non-Illinois wages as shown on your W-2 are incorrect, you must **attach** a letter from your employer, on company letterhead, stating the correct amount of non-Illinois wages. We will not accept a letter from you or your tax preparer. … (emphasis in original).
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> (Dept. Ex. #2, 4; Taxpayer Ex. B, C, D)

7. The taxpayers did not attach a letter from ABC Business regarding non-Illinois wages with their amended returns, and they did not provide a letter from ABC Business during the hearing. John Doe tried to obtain a letter from ABC Business, but ABC Business would not issue one because the days that John Doe worked in New York "were based on [his] personal calendar" and not officially directed by ABC Business. (Taxpayer Ex. B, C; Tr. p. 13)
8. On June 25, 2013, the Department issued two Notices of Claim Denial that denied the taxpayers' claims for refund for the years 2009 and 2010 on the basis that the taxpayers are not entitled to a credit for the taxes paid to New York. Copies of the Notices were admitted into evidence under the certificate of the Director of the Department. (Dept. Ex. #1, 3)

CONCLUSIONS OF LAW:

Section 201(a) of the Illinois Income Tax Act ("Act") (35 ILCS 5/101 *et seq.*) imposes a tax on the privilege of earning or receiving income in or as a resident of Illinois. 35 ILCS

5/201(a). The tax is measured by net income, which is calculated by starting with the taxpayers' federal adjusted gross income. 35 ILCS 5/201(a); 203. Section 203 of the Act sets forth modifications to the taxpayers' federal adjusted gross income that are used to calculate the taxpayers' base income. 35 ILCS 5/203; 86 Ill. Admin. Code §100.2470. Article 3 of the Act is titled "Allocation and Apportionment of Base Income," and the portion of the taxpayers' base income that is allocable to Illinois under the provisions of Article 3 is used to calculate the taxpayers' net income. 35 ILCS 5/202.

Once the taxpayers' net income is calculated and the tax is determined, the Act allows a credit for certain taxes paid to other states. The taxpayers in the present case are seeking a credit for taxes that they paid to New York. This type of credit is set forth in section 601(b)(3) of the Act, which provides as follows:

> (3) Foreign tax. The aggregate amount of tax which is imposed upon or measured by income and which is paid by a resident for a taxable year to another state or states on income which is also subject to the tax imposed by subsections 201(a) and (b) of this Act shall be credited against the tax imposed by subsections 201(a) and (b) otherwise due under this Act for such taxable year. For taxable years ending prior to December 31, 2009, the aggregate credit provided under this paragraph shall not exceed that amount which bears the same ratio to the tax imposed by subsections 201(a) and (b) otherwise due under this Act as the amount of the taxpayer's base income subject to tax both by such other state or states and by this State bears to his total base income subject to tax by this State for the taxable year. **For taxable years ending on or after December 31, 2009, the credit provided under this paragraph for tax paid to other states shall not exceed that amount which bears the same ratio to the tax imposed by subsections 201(a) and (b) otherwise due under this Act as the amount of the taxpayer's base income that would be allocated or apportioned to other states if all other states had adopted the provisions in Article 3 of this Act bears to the taxpayer's total base income subject to tax by this State for the taxable year.** The credit provided by this paragraph shall not be allowed if any creditable tax was deducted in determining base income for the taxable year. Any person claiming such credit shall attach a statement in support thereof and shall notify the Director of any refund or reductions in the amount of tax claimed as a credit hereunder all in such manner and at such time as the Department shall by regulations prescribe. 35 ILCS 5/601(b)(3).

In other words, the credit allowed under this provision is "the smaller of either the total amount of taxes paid to other states for the year or the product of Illinois income tax otherwise due (before taking into account any Article 2 credit or the foreign tax credit allowed under IITA Section 601(b)(3)) multiplied by a fraction equal to the amount of the taxpayer's base income that is sourced outside Illinois using the allocation and apportionment provisions of Article 3 of the IITA, divided by the taxpayer's Illinois base income." 86 Ill. Admin. Code §100.2197(e).

In order to determine how much of the taxpayers' base income is allocated or apportioned to New York, the relevant statutory provision is section 304(a)(2)(B), which provides, in relevant part, as follows:

> (B) Compensation is paid in this State if:
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> (i) The individual's service is performed entirely within this State;
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> (ii) The individual's service is performed both within and without this State, but the service performed without this State is incidental to the individual's service performed within this State; or
>
> (iii) Some of the service is performed within this State and either the base of operations, or if there is no base of operations, the place from which the service is directed or controlled is within this State, or the base of operations or the place from which the service is directed or controlled is not in any state in which some part of the service is performed, but the individual's residence is in this State.
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> (iv) Compensation paid to nonresident professional athletes. …
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> 35/ILCS 5/304(a)(2)(B).

The Multistate Tax Commission Allocation and Apportionment Regulations include a definition of "base of operations" that provides as follows:

> The term "base of operations" is the place of more or less permanent nature from which the employee starts his work and to which he customarily returns in order to receive instructions from the taxpayer or communications from his customers or other persons or to replenish stock or other materials, repair equipment, or

> perform any other functions necessary to the exercise of his trade or profession at some other point or points. Reg. IV.14.

Under these provisions, all of John Doe's income from ABC Business is considered to be compensation paid in Illinois. John Doe worked in New York for only 8 days in 2009 and 12 days in 2010, and his base of operations was Illinois. Because all of John Doe's income from ABC Business is compensation paid in Illinois, the amount of his income allocated or apportioned to New York is zero.

The taxpayers have not disputed the Department's finding that the amount of the taxpayers' base income that is allocated or apportioned to New York is zero. Because this amount is zero, the ratio of their base income that is allocated to New York to their total base income is also zero, and the amount of the credit for taxes paid to New York is zero. See 86 Ill. Admin. Code §100.2197(e), example 4.

The taxpayers' sole argument is that Illinois' failure to give the taxpayers credit for the tax paid to New York violates the Commerce Clause of the U.S. Constitution. "It is well settled that an administrative agency has no authority to declare a statute unconstitutional or even to question its validity." Home Interiors and Gifts, Inc. v. Department of Revenue, 318 Ill. App. 3d 205, 210 (1st Dist. 2000) *citing* Texaco-Cities Service Pipeline Co. v. McGaw, 182 Ill. 2d 262, 278 (1998). The issue, however, should be raised at the administrative level in order to preserve the issue for appeal. Texaco-Cities, at 278-279. Although this agency has no authority to find the application of the statute to be unconstitutional, because I believe the statute is constitutional, this issue will be addressed.

By giving Congress the right to regulate interstate commerce, the Commerce Clause creates an implicit restraint on the power of a State to tax interstate commerce; this is known as the dormant commerce clause. Irwin Industrial Tool Co. v. Department of Revenue, 394 Ill.

App. 3d 1002, 1012 (1st Dist. 2009). The dormant commerce clause does not prohibit all State taxation of interstate commerce, but only that which is unduly restrictive or discriminatory. *Id*. at 1013.

In order to avoid unconstitutionally burdening interstate commerce, a State tax must satisfy the four-pronged test articulated in Complete Auto Transit, Inc. v. Brady, 430 U.S. 274 (1977). A State tax will be consistent with the dormant commerce clause if "the tax is (1) applied to an activity with a substantial nexus with the taxing State; (2) is fairly apportioned; (3) does not discriminate against interstate commerce; and (4) is fairly related to the services provided by the State." *Id*. at 279. The party raising a commerce clause challenge to a State tax carries the burden of persuasion. Irwin Industrial, at 1013.

The taxpayers argue that the tax, as applied by the Department, negatively impacts interstate commerce because it places a higher overall tax burden on Illinois residents who engage in business outside of Illinois than it does on residents who conduct business solely in Illinois. The taxpayers contend that the Commerce Clause is designed to prevent this type of disproportionate tax treatment.

According to the taxpayers, the application of the tax in this case does not meet the second and third requirements of the Complete Auto test. With respect to the second requirement that the tax be fairly apportioned, the purpose of this requirement "is to ensure that each State taxes only its fair share of an interstate transaction." Goldberg v. Sweet, 488 U.S. 252, 260-261 (1989). The Supreme Court has set forth "internal consistency" and "external consistency" tests to determine whether a tax is fairly apportioned. *Id*.

A tax is internally consistent when interstate commerce does not bear more tax than intrastate commerce if every State were to impose the same tax as the one at issue. Oklahoma

Tax Commission v. Jefferson Lines, Inc., 514 U.S. 175, 185 (1995). "This test asks nothing about the degree of economic reality reflected by the tax, but simply looks to the structure of the tax at issue to see whether its identical application by every State in the Union would place interstate commerce at a disadvantage as compared with commerce intrastate." *Id.* "A failure of internal consistency shows as a matter of law that a State is attempting to take more than its fair share of taxes from the interstate transaction, since allowing such a tax in one State would place interstate commerce at the mercy of those remaining States that might impose an identical tax." *Id.*

The taxpayers in the present case argue that the Illinois law fails the internal consistency test. The taxpayers contend that under the Illinois law, a person who operates in interstate commerce is subject to tax in both the State where the income is earned as well as the State where the person resides. The taxpayers claim that this burdens interstate commerce, and therefore, the tax is not fairly apportioned.

The taxpayers also argue that the tax discriminates against interstate commerce because it increases the costs of doing business in interstate commerce. The taxpayers claim that this has a chilling effect on people who are involved in multi-state businesses. In addition, the taxpayers believe that Illinois' requirement that an incorrect W-2 be supported by a letter from the taxpayer's employer is further proof that interstate commerce is unduly burdened by failing to give credit when a letter is not provided. In the taxpayers' view, the New York audit is sufficient documentation to support a credit for taxes that were paid to New York.

The Department notes that John Doe's W-2's indicated that all of his income was based in Illinois, and he was not able to obtain a letter from his employer to substantiate his claim that part of his income was sourced to New York. The Department also states that the U.S. Supreme

Court recently addressed the internal consistency test in Comptroller of the Treasury of Maryland v. Wynne, 135 S.Ct. 1787 (2015), where the court stated as follows:

> This test, which helps courts identify tax schemes that discriminate against interstate commerce, 'looks to the structure of the tax at issue to see whether its identical application by every State in the Union would place interstate commerce at a disadvantage as compared with commerce intrastate.' [citations omitted]
>
> By hypothetically assuming that every State has the same tax structure, the internal consistency test allows courts to isolate the effect of a defendant State's tax scheme. This is a virtue of the test because it allows courts to distinguish between (1) tax schemes that inherently discriminate against interstate commerce without regard to the tax policies of other States, and (2) tax schemes that create disparate incentives to engage in interstate commerce (and sometimes result in double taxation) only as a result of the interaction of two different but nondiscriminatory and internally consistent schemes. *Id*. at 1802.

The Department argues that John Doe cannot claim a credit for the taxes paid to New York because if the facts were reversed, Illinois would not be able to tax the wages of a New York resident doing similar work in Illinois under similar circumstances. "Stated differently, if every state employed the same apportionment method as Illinois, the income would only be sourced to and taxed by one jurisdiction, making it internally consistent." (Dept. Reply p. 2) In addition, the Department notes that John Doe's base of operations was clearly Illinois, and therefore, none of his income was allocable to New York.

The Department's arguments are persuasive, and the statute is constitutional as applied to the taxpayers in this case. As the Department has indicated, if every State in the Union had an apportionment rule that was identical to the Illinois statute, then the income would be sourced to only one state. In other words, if New York had a statute that is identical to the Illinois statute, the portion of John Doe's income that would be allocated to New York would still be zero. The internal consistency test is designed to prevent discrimination against interstate commerce and

not necessarily avoid double taxation. Wynne, *supra*. The Illinois statute, therefore, is internally consistent.

The New York audit is not sufficient documentation to support a credit in this case because the audit is not relevant to determining whether the income that John Doe received while working in New York was Illinois compensation pursuant to section 304(a)(2)(B). As stated previously, the taxpayers do not dispute (and the facts support) the Department's finding that John Doe's base of operations was Illinois. The amount of his income that is allocated to New York, therefore, is zero.

Recommendation:

For the foregoing reasons, it is recommended that the Notices of Claim Denial for the years 2009 and 2010 be finalized as issued.

Linda Olivero
Administrative Law Judge

Enter: February 23, 2016