

IT 17-03
Type of Tax: Income Tax
Issue: Income Tax Foreign Tax Credit

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

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

v.

JOHN AND JANE DOW,

Taxpayers

No. 15-IT-XXX
Account ID P00000000
Letter ID CNXXX000000000001
Tax Year 2011

Ted Sherrod
Administrative Law Judge

RECOMMENDATION FOR DISPOSITION

Appearances: Special Assistant Attorney General Ronald Forman on behalf of the Illinois Department of Revenue; Thomas McGuire of Arnstein & Lehr LLP on behalf of John and Jane Dow.

Synopsis:

This matter is before this administrative tribunal as the result of a timely protest by John and Jane Dow (hereinafter referred to as "Taxpayers") of the Illinois Department of Revenue's denial of the Taxpayers' claim for credit against income tax due for the tax year ending December 31, 2011 for taxes paid to New York on compensation for services performed in that State. The sole issue presented by the Taxpayers' protest is whether the

denial of this credit violates the dormant commerce clause of the United States Constitution.

In their protest, the Taxpayers requested a hearing in this matter. However, in lieu of a hearing, the parties have submitted an “Agreed Stipulation of Facts and Waiver of Evidentiary Hearing” (“Stipulation”) along with Joint Exhibits 1-12. Following the submission of all evidence and a review of the record, it is recommended that this matter be resolved in favor of the Department of Revenue (“Department”). In support of this recommendation, the following “Findings of Fact” and “Conclusions of Law” are made.

Findings of Fact:

1. John and Jane Dow ("Taxpayers") are married to one another and were full-time residents of the State of Illinois during calendar year 2011. Stipulation 1.
2. John Dow was, and continues to be employed as an investment banker. Stipulation 2.
3. During calendar year 2011, John Dow was employed for part of the year by THIS COMPANY, LLC and for the balance of year by That Company (USA), Inc. Stipulation 3.
4. For both of the foregoing jobs, John Dow was based in the State of Illinois. However, the nature of his occupation required him to spend a significant amount of time in the State of New York. As such, both employers withheld both Illinois and New York income tax from his salary. Stipulation 4.
5. John Dow’s wages and other taxable compensation from THIS COMPANY LLC for 2011 as reflected on his Form W-2 was \$X,XXX,XXX. With respect to these

- earnings, the W-2 shows Illinois income tax withheld of \$XX,XXX and New York income tax withheld of \$XX,XXX. Stipulation 5.
6. John Dow's wages and other taxable compensation from THIS COMPANY (USA), Inc. for 2011 as reflected on his Form W-2 was \$XXX,XXX. With respect to these earnings, the W-2 shows Illinois income tax withheld \$XX,XXX and New York income tax withheld of \$X,XXX. Stipulation 6.
 7. As an Illinois resident, John Dow filed a 2011 Form IL-1040 reporting the entire amount of his wages and other taxable income on his return, resulting in a computation of Illinois income tax, before credits, of \$XX,XXX. Stipulation 7.
 8. On line 17 of his Form IL-1040, and line 55 of his 2011 Schedule CR, John Dow took a "credit for taxes paid to other states" (that is, taxes paid to New York) in the amount of \$XX,XXX. This result was based upon records and information provided John Dow by his employer showing that approximately 16 percent of his time was spent working in the State of New York, resulting in \$XXX,XXX of his wages and other income from employment being allocated to New York on line 1, column B of Schedule CR. Stipulation 8.
 9. John Dow likewise filed a non-resident New York income tax return (Form IT-203) for the calendar year 2011 which reported \$XXX,XXX of his wages as being taxable in New York, resulting in New York income tax liability of \$XX,XXX. Stipulation 9.
 10. The Illinois Department of Revenue ("Department") subsequently denied the credit for taxes paid to other states, giving John and Jane Dow a zero credit on line 17 of their 2011 Form IL-1040 and line 55 of Schedule CR, ultimately

resulting in an appeal decided in Department of Revenue v. John and Jane Dow, No. 14-IT-213, Department of Revenue Office of Administrative Hearings, January 14, 2015. The disallowance of the credit was based on the Department's determination that none of the income on line 1, Column B of Schedule CR was non-Illinois income. Stipulation 10.

11. By Recommendation for Decision dated January 14, 2015, Administrative Law Judge Kelly Yi in John and Jane Dow, *supra* recommended a decision in favor of the Department, finding that the provisions of the Illinois Income Tax Act warranted a determination that Illinois had the authority to tax 100 percent of John Dow's income, without a corresponding credit for income tax paid to the State of New York. This Recommendation for Decision was accepted, and a Notice of Decision in favor of the Department and against the Taxpayers was issued on March 19, 2015. Stipulation 11.
12. On May 18, 2015, shortly after the Notice of Decision against the Taxpayers was entered, the United States Supreme Court entered its decision in Comptroller of the Treasury of Maryland v. Wynne, 135 S. Ct. 1787 (2015) which raises certain Constitutional issues in situations involving the double taxation of a taxpayer's income. Stipulation 12.
13. Taxpayers contend that the rationale of the Wynne decision, if applied to John Dow's situation, would result in the provisions of the Illinois Income Tax Act (as construed in John and Jane Dow, *supra*) being deemed to be an unconstitutional double taxation of income. The Taxpayers therefore believe the prior Notice of Decision now needs to be reversed, and as a result, the Taxpayers have filed their

appeal in the instant case. The Department disagrees and believes that the application of section 601(b)(3) of the Illinois Income Tax Act, 35 ILCS 5/601(b)(3) is constitutional and consistent with the decision in Wynne. Stipulation 13.

14. The amount in controversy is the entire amount of the claimed credit for taxes paid to the State of New York, in the amount of \$XX,XXX, plus any interest and penalties which have been assessed relating to this matter. Stipulation 14.

Conclusions of Law:

On September 14, 2015, John and Jane Dow filed an Illinois Form EAR-14, Protest for Income Tax for the tax year ended 12/31/11. Agreed Stipulation of Facts and Waiver of Evidentiary Hearing Joint Exhibit 12. The purpose of this submission was to formally protest the Department's Notice of Claim Denial stating that the above - referenced Taxpayers are not entitled to an Illinois income tax credit in the amount of \$XX,XXX for taxes paid to New York on compensation earned for services performed in New York. John Dow, one of the Taxpayers, contends that he worked in both Illinois and New York during 2011 and that New York taxed a portion of the Taxpayers' income that was also taxed by Illinois. The Taxpayers claim that they are entitled to a credit for taxes paid to New York under section 601(b)(3) of the Illinois Income Tax Act, 35 ILCS 5/601(b)(3) which governs the allowance of credits against Illinois income taxes for "foreign tax" paid to other states.

In Department of Revenue v. John and Jane Dow, 14-IT-213 (Department of Revenue Office of Administrative Hearings, January 14, 2015), a prior case before the Department which resulted in the denial of the identical credit for taxes paid to New York

for 2011 at issue in this case, the Taxpayers contended that Department of Revenue Regulation 100.2197(b)(4)(E), 86 Ill. Admin. Code, ch. I, section 100.2197(b)(4)(E) expressly provides a credit to the Taxpayers for compensation paid in New York in this case. Section 100.2197(b)(4)(E) provides as follows:

For taxable years beginning prior to January 1, 2006, compensation paid in Illinois under IITA Section 304(a)(2)(B), as further explained in Section 100.3120 of this Part, is not included in double-taxed income, even if another state taxes such compensation. For example, an Illinois resident whose base of operations is in Illinois, but whose employment requires him or her to work in Illinois and for a substantial period of time in State Z, must treat all compensation from such employment as paid in Illinois under IITA Section 304(a)(2)(B)(iii). None of that compensation may be included in double-taxed income, even if State Z actually taxes the compensation earned for periods during which the resident was working in State Z. Public Act 94-247 (effective January 1, 2006) repealed the provision in IITA Section 601(b)(3) that stated compensation paid in Illinois may not be included in double-taxed income, and so compensation paid in Illinois may be included in double-taxed income in taxable years beginning on or after January 1, 2006.

The Taxpayers argue that the facts in the example given in the above regulation are identical to the facts in the instant case because John Dow, an investment banker, had his base of operations at two investment banking firms in Illinois during 2011 and was required by his employers to work 47 days in New York during that year.

The Department, in its decision in John and Jane Dow, *supra*, accepts the Taxpayers' contention that section 100.2197(b)(4)(E), as applied to the facts in the instant case, provides a legal rationale for the Taxpayers' claim to the credit for taxes paid to New York the Taxpayers are seeking. However, the Department, in its decision, rejects the Taxpayers' claim for credit based upon section 100.2197(b)(4)(E) of the Department's regulations because this regulation, upon which the Taxpayers seek to rely,

construes section 601(b)(3) of the Illinois Income Tax Act as in effect prior to amendments to this provision effective December 31, 2009 and applicable to tax years preceding the tax year in controversy, 2011. Section 601(b)(3) as in effect for the tax year in controversy, 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 subsection 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.

Pursuant to section 601(b)(3) of the Illinois Income Tax Act as amended and effective in 2009 and applicable to the tax year in controversy, the Taxpayers were allowed an Illinois income tax credit for taxes paid to New York only on income apportioned to New York according to Article 3 of the Illinois Income Tax Act using the same sourcing rules that would apply if all of John Dow's income earned in New York

had been earned in Illinois. Prior to amendments to section 601(b)(3) effective in 2009, the credit was computed based upon the income actually taxed in New York, with a credit being allowed if any portion of this income was also taxed by Illinois. However, as a consequence of the law change to section 601(b)(3) effective in 2009, the amount of income actually taxed by both Illinois and New York is disregarded and a determination is made whether any such income would have been taxable in New York had New York used the same apportionment rules used by Illinois under Article 3 of the Illinois Income Tax Act for determining taxes due on income earned outside of New York.

Applying the sourcing rules indicated in Article 3 of the Illinois Income Tax Act to determine the amount of credit for taxes paid to New York allowable in the instant case, the Department determined that none of the Taxpayers' income was apportionable to New York. In reaching this decision, the Department, in Thomas and Elizabeth Devine, *supra* reasoned that, under Illinois apportionment rules, compensation would be deemed to be paid in New York and subject to taxation in that state only if one of the following three conditions as enumerated under Article 3 of the Illinois Income Tax Act in section 304(a)(2)(B) are satisfied:

- (i) The individual's service is performed entirely within the State (in the instant case, for purposes of determining the foreign tax credit at issue, New York);
- (ii) The individual's service is performed both within and without the State (here New York), but the service performed without this State is incidental to the individual's service performed within this State (New York), or
- (iii) Some of the service is performed within this State (here New York) 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 (New York).
35 ILCS 5/304(a)(2)(B)

In 14-IT-213, *supra*, the Department determined that no portion of the Taxpayers' 2011 income was sourced to New York under these sourcing rules because John Dow's services were only partially performed in New York and therefore deemed to be incidental to services performed at his base of operations in Illinois. As a consequence of the Department's determination, one hundred percent of the John Dow's income was deemed to be sourced to Illinois under the sourcing provisions of Article 3, enumerated at section 304(a)(2)(B).

Subsequent to the Department's decision in 14-IT-213, *supra* the United States Supreme Court determined in Comptroller of the Treasury of Maryland v. Wynne, et al, 135 S. Ct. 1787 (2015) that a Maryland income tax statute that did not offer its residents "a full credit against the income taxes they pay to other states" (Wynne, supra at 1792) violated the federal Constitution based upon the "dormant commerce clause". The Court concluded that the "dormant commerce clause" prevents states from "discriminating between transactions on the basis of some interstate element" (Wynne, supra at 1794) and concluded that a state may not impose a tax that subjects interstate commerce to the "burden on multiple taxation." *Id.* The sole issue presented in the instant case is whether the Illinois income tax apportionment provisions as construed in the Department's decision in 14-IT-213, *supra* to deny the Taxpayers a credit on compensation actually taxed by both Illinois and New York violates the Supreme Court's ban on taxes that "discriminate between transactions on the basis of some interstate element" and therefore is unconstitutional.

The Department has determined that the construction of section 601(b)(3) indicated in 14-IT-213, *supra* constitutes a correct construction of this provision as amended and effective for the tax year in controversy. While, as indicated by Department regulation section 100.2197(b)(4)(E), the Taxpayers would qualify for a credit for taxes paid to New York pursuant to section 601(b)(3) prior to its amendment effective in 2009, as to the year at issue, section 601(b)(3) bars the Taxpayers from receiving any such tax credit.

The Taxpayers, in effect, are contending that changes to section 601(b)(3) effective in 2009 resulting in the denial of the foreign tax credit at issue in the instant case are unconstitutional in light of the Supreme Court's determination in Wynne. In an administrative hearing, the Department's statutes are presumptively constitutional and the administrative law judge is, therefore required to uphold the statute's constitutionality. Board of Education of Rich Township High School District No. 227 v. Brown, 311 Ill. App. 3d 478, 490 (1999). This is true because an administrative agency has no inherent or common law powers; any authority that the agency claims must find its source within the provisions of the statute by which it was created. Department of Revenue v. Civil Service Commission, 357 Ill. App. 3d 352, 363 (1st Dist. 2005); Parliament Insurance Company v. Department of Revenue, 50 Ill. App. 3d 341, 347 (1st Dist. 1977). An administrative agency lacks the 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); see also Arvia v. Madigan, 209 Ill. 2d 520, 526 (2004). The

constitutional issue must be raised at the administrative level however in order to preserve the issue for appeal. Texaco-Cities, *supra* at 278, 279.

Applying the forgoing settled law in the instant case, section 6031(b)(3) as construed by the Department in 14-IT-213, *supra*, is presumed to be constitutional. Consequently, the Department's administrative law judge in the instant case does not have the authority to rule on the constitutional issue raised based upon the Wynne decision, which is the sole issue raised by the Taxpayers in this case. Nevertheless, because this issue has been raised it is preserved in the event the Taxpayers decide to seek administrative review.

Recommendation:

For the foregoing reasons, I recommend that the Director finalize the Notice of Claim Denial denying the Taxpayer's claim for credit for taxes paid to New York for 2011, the tax year at issue in this case.



Ted Sherrod
Administrative Law Judge

Date: November 2, 2016