

IT 04-8

Tax Type: Income Tax

Issue: Net Operating Loss Carryback

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

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

v.

**JOHN & JANE DOE,
Taxpayers**

**No. 03-IT-0000
SSN: 0000000000
Tax yrs.: 1996-1998**

**Charles E. McClellan
Administrative Law Judge**

ORDER ON CROSS-MOTIONS FOR SUMMARY JUDGMENT

Appearances: Deborah H. Mayer, Special Assistant Attorney General, for the Illinois Department of Revenue (the "Department"); James M. Delahunt for *John & Jane Doe* ("Taxpayers")

Background:

This matter arose from a timely protest filed by Taxpayers to three Amended Income Tax Letters (Form LTR-405) issued by the Department on June 27, 2003 to Taxpayers partially denying Taxpayers' refund claims for the calendar years 1996, 1997 and 1998. Taxpayers filed federal refund claims based on a year 2001 federal net operating loss ("NOL") carried back to those years as provided by Internal Revenue Code, 26 U.S.C § 1, *et seq.* ("IRC"). Taxpayers' Illinois refund claims for those years are based on the federal adjustments to their adjusted gross income and taxable income resulting from their NOL carryback deductions. Before any pre-trial conference, Taxpayers filed their motion for summary judgment. The Department responded with its cross-motion for summary judgment. Taxpayers then filed a response to the

Department's cross-motion for summary judgment. Finally, the Department asked for leave to file a reply to Taxpayers' response, which was granted, and the Department filed its reply. The parties agree that there is no genuine issue of material fact, and that summary judgment is appropriate.

The issue raised by the Taxpayers' motion is whether the Department incorrectly adjusted Taxpayers' modified adjusted gross income for each of the carry-back years to prevent a potential double deduction on Taxpayers' Illinois income tax returns of a portion of a federal NOL Taxpayers incurred for the year 2001. I find that the Department's adjustments are correct, so I am denying Taxpayers' motion for summary judgment and granting the Department's cross-motion for summary judgment.

Undisputed Facts:

1. Taxpayers filed a federal income tax return (Form 1040) for the calendar year 2001 reporting negative adjusted gross income in the amount of \$1,442,491. Dept. Ex. No. 3.
2. Taxpayers filed a federal Form 1045- *Application for Tentative Refund* reporting a federal NOL of \$1,312,778 for 2001 that they carried back to 1996, 1997, 1998, 1999, and 2000, ("carryback years"). *Id.*
3. Taxpayers' Form 1045 reported available NOL deduction carrybacks as follows:

Carryback year	NOL carrybacks
1996	\$1,312,778
1997	\$1,102,105
1998	\$890,922
1999	\$578,005
2000	\$545,199

Id.

4. Pursuant to provisions of the Illinois Income Tax Act¹, Taxpayers then filed Forms IL-1040-X *Amended Individual Income Tax Return* for the years 1996, 1997, and 1998 to claim refunds for each year on the basis of their modified adjusted gross income resulting from their federal NOL carryback adjustments to those years. *Id.*
5. In calculating their Illinois refund claims, Taxpayers subtracted from the NOL carryback deduction reported on its Form 1045 the amount of its adjusted gross income originally reported before the NOL deduction as follows:

Carryback year	Adjusted gross income
1996	\$237,919
1997	\$239,965
1998	\$333,556
<i>Id.</i>	

6. In this case, the Department reduced the refund claims for 1996, 1997, and 1998, by determining the modified adjusted gross income and the amount of NOL carryback to the next preceding carryback year from the information Taxpayers reported on their Form 1045 for each claim year. Dept. Ex. No. 4, Dept. Reply,² p. 3.

Conclusions of Law:

Summary judgment is appropriate where there is no genuine issue of material fact and a movant is entitled to judgment as a matter of law. 735 ILCS 5/2-1005, *Eidson v. Audrey's CTL, Inc.*, 251 Ill. App. 3d 193, 621 N.E. 2d 921 (5th Dist. 1993), *app. den.*, 154 Ill.2d 558, 631 N.E. 2d 706 (1993). It also is appropriate when the parties dispute the correct construction of an

¹ Unless otherwise noted, all statutory references are to 35 ILCS 5/101, *et seq.*, the Illinois Income Tax Act (“IITA” or the “Act”).

applicable statute. *Bezan v. Chrysler Motors Corp.*, 263 Ill. App. 3d 858, 636 N.E. 2d 1079 (2nd Dist. 1994). In this case, the parties agree that there is no genuine issue of material fact. The issue involves the proper construction of the statutory provisions in the IITA for calculating refunds based on federal NOL carryback deductions that reduce Taxpayers' previously reported adjusted gross income and taxable income.

An individual who incurs a federal NOL in one year can carry it back to the carryback years for federal income tax purposes. The five years preceding the loss year were the carryback years for the years at issue in this case. The NOL carryback adjustments reduce adjusted gross income by the amount of NOL carryback deduction calculated under the statute. The excess of the NOL carryback to the fifth carryback year (1996 in this case) is carried back to the fourth carryback year (1997 in this case) and so on until it has been deducted in its entirety. Treas. Reg. § 1.172-3.

For the years at issue in this case, when an individual taxpayer incurs a loss for a year that resulted in negative adjusted gross income on his federal income tax return, a NOL deduction is calculated by making statutorily prescribed adjustments to his adjusted gross income to calculate his modified adjusted gross income. The NOL is then carried back to the earliest carryback year. Treas. Reg. § 1.172-3. The amount of the NOL that is offset against the taxpayer's modified taxable income for the earliest carryback year reduces the amount of NOL carryover to the next preceding carryback year. This process continues into succeeding years until the amount of the NOL is exhausted. Treas. Reg. §§ 1.172-4, 1.172-5.

To determine a taxpayer's modified adjusted gross income, certain adjustments are made, including the elimination of the deduction for exemptions and the amount of losses from sales or

² The *Department's Reply to Taxpayers' Response to Department's Cross-Motion for Summary Judgment* is referred to herein as "Dept. Reply".

exchanges of capital assets that exceed the amount of capital gains. *Id.* Because some itemized deductions, such as the deduction for medical expenses, are limited to an amount exceeding a specified percentage of adjusted gross income, adjustments are calculated to bring the itemized deductions claimed on the original income tax return within the newly calculated limits. *Id.* The amount of a taxpayer's modified deductions plus the exemption amounts he is entitled to are then added to the taxable income originally reported. *Id.* That sum becomes his modified taxable income which, when deducted from his NOL deduction, determines his NOL carryover to the next preceding carryover year. *Id.* In no event can the modified taxable income be less than zero. *Id.* The taxpayer's modified taxable income then becomes the basis for the recalculation of his tax liability for the carryback year, and that recalculated liability is the basis for calculating his federal refund claim. *Id.*

In a case such as this one in which a taxpayer's NOL deduction results in a negative adjusted gross income on his federal income tax return for federal income tax purposes, the taxpayer's adjusted gross income is limited under these rules to the amount of the taxpayer's adjusted itemized deductions and exemptions thereby reducing his taxable income to zero. As noted above, in no case can a taxpayer's taxable income be less than zero for federal income tax purposes. The balance of a taxpayer's NOL deduction for federal income tax purposes is carried over to the next preceding carryback year and this process continues until the original NOL has been exhausted.

The IITA provides that the starting point for calculating an individual taxpayer's Illinois income tax liability is adjusted gross income as calculated for federal income tax purposes. 35 ILCS 5/203(a). The IITA does not provide for a separate NOL deduction for individuals. However, a taxpayer can file Illinois refund claims based, in effect, on the federal modified

adjusted gross income taking the NOL deduction into account for the carryback years. IITA § 203(e)(1).

The legislature recognized that calculating modified taxable income resulting from NOL deductions on federal income tax returns differs from the calculation of taxable income on Illinois income tax returns. This difference created the possibility that a taxpayer might be able to obtain a double deduction for part of a NOL. The possibility of a double deduction for part of a NOL arises because the IITA provides for addition and subtraction modifications to adjusted gross income specified in IITA §§ 203(a)(1) and (2). The Internal Revenue Code does not have similar adjustments. Thus, a taxpayer could offset net addition modifications on his Illinois income tax return with negative adjusted gross income created by the federal NOL deduction. However, that part of the taxpayer's NOL reduction that offsets net addition modifications would not reduce the NOL carried forward to the next carryback year for federal purposes, so it would continue to be included in the taxpayer's NOL carryover to the next preceding carryback year where it would be a federal deduction in arriving at adjusted gross income. That would result in a double deduction of the modification-offset amount for the next preceding carryback year.

To prevent such a result the legislature enacted two subsections to IITA § 203. These subsections provide as follows:

(g) Double deductions. Unless specifically provided otherwise, nothing in this Section shall permit the same item to be deducted more than once. 35 ILCS 5/203(g).

(h) Legislative intention. Except as expressly provided by this Section there shall be no modifications or limitations on the amounts of income, gain, loss or deduction taken into account in determining gross income, adjusted gross income or taxable income for federal income tax purposes for the taxable year, or in the amount of such items entering into the computation of base income and net income under this Act for such taxable year, whether in respect of property values as of August 1, 1969 or

otherwise. 35 ILCS 5/203(h)

These two provisions in the statute prohibit double deductions and authorize the Department to modify a taxpayer's adjusted gross income to prevent them.

In this case, the Department adjusted Taxpayers' refund claims so that the amount of the loss taken into account for Illinois purposes in each carryback year eliminated the possibility of a double deduction. The Department's adjustments to Taxpayers' refund claims for 1996, 1997, and 1998 are correct. The Department's position is consistent with the rationale of the court in *Madison Park Bank v. Department of Revenue*, 97 Ill.App.3d 743, 423 N.E.2d 939 (3rd Dist. 1981), judgment vacated and cause dismissed 92 Ill.2d 638, 437 N.E.2d 638. Although the Supreme Court dismissed the case as being moot because the Taxpayer conceded it had already used all of its NOL carryback in a prior year, the Court left intact the appellate court's ruling barring double NOL deductions.

Finally, the Department's determination is consistent with the rules of statutory construction. "Statutes are to be construed so that no term is rendered superfluous or meaningless." *Texaco-Cities Service Pipeline Company v. McGaw*, 182 Ill.2d 262, 270; 695 N.E.2d 481, 485 (1998). Taxpayers' construction of IITA § 203 would render IITA §§ 203(g) and (h) meaningless, because Taxpayers' construction of the statute would not prevent a double deduction of part of the federal NOL carryback.

Taxpayers maintain that the Department incorrectly "adjusted the Taxpayers' adjusted gross income (hereinafter AGI) in each of the carryback years by increasing Taxpayers' AGI in each of the taxable years to an amount equal to the Taxpayers' federal itemized deductions in such carryback year." Taxpayer Motion p. 2. That statement is incorrect. The Department reduced Taxpayers' adjusted gross income to the amount of the Taxpayers' modified taxable

income plus their adjusted itemized deductions and exemptions for those years. That is the adjustment required by the federal regulations cited previously. That adjustment reduces Taxpayers' federal taxable income to zero for the carryback years, and that amended adjusted gross income becomes the starting point for calculating Taxpayers' IITA refund claims.

Taxpayers argue that the Department is exceeding its authority by adjusting Taxpayers' adjusted gross income. Taxpayer asserts that IITA § 203(h) prohibits modifications to Taxpayers' adjusted gross income except as required by IITA § 203(a)(1). Taxpayers are incorrect for two reasons. First, the Department is adjusting Taxpayers' adjusted gross income to the amount of their modified adjusted gross income which, after the net operating loss deduction, is their "adjusted gross income as properly reported for federal income tax purposes" as required by the statute.

Second, Taxpayer ignores the language in IITA §§ 203 (g) and (h). IITA § 203(h) makes it clear that a modification can be made to avoid a double deduction which is barred by IITA § 203(g). Thus, the Department's position is consistent with the language of the statute and with legislative intent.

In support of their position, Taxpayers cite a question and answer from a Department of Revenue practitioners' forum in which the question asked was when does a taxpayer have an Illinois NOL. <http://www.revenue.state.il.us/LegalInformation/practqna/2002>. The answer given was that an individual is automatically allowed the benefit of his or her federal NOL deduction as it is taken into account in calculating the taxpayer's federal taxable income, and that there is no separate Illinois operating net loss carryover for individuals. Taxpayers then conclude that the Department "has taken the position that in a carryback of an NOL, the starting point (AGI after NOL carryback) cannot be less than zero." Taxpayer Motion p. 4. Taxpayer then argues that there is no provision in the IITA authorizing that position. *Id.* Although the answer given at

the forum is correct as far as it goes, it does not take into account the provisions of IITA §§ 201(g) and (h). Therefore, the answer does not support Taxpayers' position.

Taxpayers also challenge the Department's IL-1040-X filing instructions regarding the calculation of refund claims based on federal NOL carrybacks. That language provides, in pertinent part, as follows:

Illinois does not allow you to deduct the same NOL twice. To prevent a double deduction of your NOL, your deduction for a tax year cannot be greater than the federal NOL available for deduction in that year minus the federal NOL available to carry to later years. This is the amount reported as "Modified Taxable Income" on federal Form 1045, Application for Tentative Refund, Schedule B." Dept. Ex. No. 7.

It is important to note that by statute, the Department's forms and instructions have the force of regulations. 35 ILCS 5/1501(a)(19). Contrary to Taxpayers' position, there is nothing in these instructions that conflicts with the law. The instructions merely restate the law taking into account the provisions of IITA §§ 203(g) and (h) prohibiting double deductions of NOL carryback adjustments.

Next, Taxpayers cite the Department's regulation 86 IL. Admin. Code § 100.2410 added at 86 Ill. Reg. 1378, effective January 12, 2004. Taxpayers acknowledge that this regulation was not effective until January 12, 2004, but state that it "is instructive in the instant case because it provides that taxpayers with adjusted gross income that is less than zero for a taxable year may offset such negative amount against any net addition modifications for the taxable year to the extent the negative income has not been carried back to and deducted in any prior taxable year as a loss deduction. That is, the regulation defines a 'double deduction' on a cumulative basis, without mention of itemized deductions." Taxpayer Motion p. 4. Taxpayers go on to state that due to the size of their NOL "there was NO double deduction through the years at issue under

Illinois law because the taxpayers still have a substantial carryforward of their NOL.” [emphasis in the original.] *Id.*

Although Taxpayers did not cite the particular subsection of Reg. § 100.2410 they are referring to, it appears to be 86 IL. Admin. Code § 100.2410(c)(1) that provides, in relevant part, as follows:

Taxpayers with taxable income (adjusted gross income, in the case of an individual) that is less than zero for a taxable year may offset such negative amount against any net addition modifications for the taxable year, but only to the extent the negative income has not been carried back to and deducted in any prior taxable year as a loss or deduction governed by this Section. (See IITA Section 203(g) (prohibiting double deductions) and *Madison Park Bank v. Zagel*. [citation omitted] The sum of carryover deductions taken in all years, plus the net addition modifications offset against the loss in the year incurred, may not exceed the amount of the loss. Notwithstanding subsection (a) of this Section, whenever a carryover deduction taken in any year plus the net addition modifications offset against a loss in the year incurred plus all carryover deductions of that loss allowed in prior years exceeds the loss incurred, such excess must be added back. 86 IL. Admin. Code § 100.2410

This regulation has nothing to do with federal itemized deductions, so there is no reason why federal itemized deductions should be mentioned in it, as Taxpayers seem to indicate. Also, the regulation was not in effect during the years at issue in this case, and the factual situation described in the regulation is not the factual situation involved in this case because the Taxpayers’ claims do not exhaust the NOL incurred.

For the reasons set forth above, Taxpayers’ Motion for Summary Judgment is denied, and the Department’s Cross-Motion for Summary Judgment is granted. Because this order disposes of all of the issues in this matter, I recommend that the three Amended Income Tax Letters (Form LTR-405) issued by the Department on June 27, be made final.

Date: 9/09/2004

Charles E. McClellan
Administrative Law Judge