

**IT 08-7**

**Tax Type: Income Tax**

**Issue: Net Operating Loss Carryback**

**Federal Change (Individual)**

**Audit Methodologies and/or Other Computational Issues**

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

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<b>THE DEPARTMENT OF REVENUE</b>	)	
<b>OF THE STATE OF ILLINOIS</b>	)	<b>Case No. 06 IT 0000</b>
	)	
	)	<b>SSN: 000-00-0000</b>
v.	)	
	)	<b>Tax Years:</b>
<b>JOHN &amp; JANE DOE,</b>	)	<b>1989, 1990, 1994 (John)</b>
	)	<b>1991 (John and Jane)</b>
<b>TAXPAYERS</b>	)	
	)	<b>Administrative Law Judge</b>
	)	<b>Kenneth J. Galvin</b>

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**RECOMMENDATION FOR DISPOSITION**

**Appearances:** Mr. James Harbert, Hinshaw & Culbertson, LLP, on behalf of John and Jane Doe; Mr. Rickey Walton, Special Assistant Attorney General, on behalf of the Department of Revenue of the State of Illinois.

**Synopsis:**

On January 18, 2006, the Illinois Department of Revenue (hereinafter "Department") issued an Amended Notice of Deficiency (hereinafter "ANOD") to John Doe, covering tax years 1989, 1990, 1994 and 1995 (of which 1989, 1990 and 1994 are at issue) and an ANOD to John and Jane Doe covering tax years 1991, 1996 and 1998 (of which 1991 is at issue). On January 23, 2008, the parties submitted a "Stipulation of Facts" and a "Stipulation of Issues," in which it was agreed that the determinations made

on the ANOD's were correct except for the following: on the ANOD issued to John, the late payment penalties for 1989 and 1990 and the late filing or nonfiling penalty for 1994 are contested; on the ANOD issued to John and Jane, the late payment penalty for 1991 is contested. The issue with regard to the penalties is whether additional income tax assessed to the taxpayers from federal audit adjustments should be reduced by net operating loss carrybacks before the computation of penalties.

Following a review of the "Stipulation of Facts," "Stipulation of Issues," supporting documentation, and the "Brief of Taxpayers John and Jane Doe," the "Department's Trial Brief and Response to Taxpayers' Trial Brief," and "Reply Brief for Taxpayers John and Jane Doe," it is recommended that both ANOD's be finalized as issued.

**Findings of Fact:**

1. On December 19, 2001, the Internal Revenue Service ("IRS") finalized an audit of John Doe for tax years ending December 31, 1986, 1987, 1988, 1989, 1990 and 1994 (of which 1989, 1990 and 1994 are at issue in this proceeding). On December 17, 2001, the IRS finalized an audit of John and Jane Doe for tax years ending December 31, 1991, 1992 and 1993 (of which 1991 is at issue). The IRS sent the Department copies of the documents memorializing the results of the federal audits. Stip. Ex. Nos. 6 and 7.
2. On or after April 21, 2002, approximately 120 days after the federal audit changes ("RAR's") were finalized, the Department computed the increase in the taxpayers' adjusted gross income ("AGI") that was attributable to the federal audits for the tax

years at issue. Based on the RAR's, the Department determined that the taxpayers' AGI increased by the amounts shown below:

<u>Tax Year</u>	<u>Increase in AGI</u>	<u>Tax Return</u>
1989	\$ 1,947,687	John
1990	\$ 8,415,694	John
1991	\$ 132,170	John and Jane
1994	\$ 3,680,001	John

Stip. Ex. No. 1 at pp. 164, 165, 166 and Stip. Ex. No. 2 at p. 190.

3. The Department included the increases in the taxpayers' AGI in the amounts that the taxpayers had reported on line 1 of their IL-1040's for the tax years at issue. Based on the revised amounts on Line 1 of the IL-1040's, the Department computed the additional tax that the Taxpayers owed because of the increase in their AGI. (Stip. Ex. No. 1 at pp. 162, 163 and Stip. Ex. No. 2 at p. 185.) Based on the additional tax computations, the Department computed the late payment and late filing penalties that are at issue in this matter. Stip. Ex. No. 1 at p. 157 and Stip. Ex. No. 2 at p. 182.
4. On October 29, 2002, the Department sent John Doe a letter regarding the RAR's for tax years 1989, 1990 and 1994. The letter informed John that the Department had received information from the IRS indicating that adjustments had been made to his federal income tax returns, and that he must file either IL-1040's or IL-1040X's. The letter stated the following: "All nonfilers are assessed a nonfiler penalty for not filing their tax when due. If you do not respond within 30 days

from the date of this notice, you will be subject to an additional penalty.” Dept. Ex. No. 21.

5. On November 14, 2003, the Department received IL-1040-X’s from John Doe for tax years 1989, 1990 and 1994, reporting the RAR’s to the Department. Dept. Ex. No. 20.
6. On November 14, 2003, the Department received an IL-1040-X from John and Jane Doe for tax year 1991. Stip. Ex. No. 2 at p. 197.
7. On January 18, 2006, the Department issued two ANOD’s to John Doe and to John and Jane Doe. The Department’s *prima facie* case, inclusive of all jurisdictional elements, is established by the ANOD’s issued to John Doe covering tax years 1989, 1990, 1994 and 1995 (of which 1989, 1990 and 1994 are at issue) and issued to John and Jane Doe, covering tax years 1991, 1996 and 1998 (of which 1991 is at issue). Stip. Ex. Nos. 1 and 2.

**Conclusions of Law:**

The issue in this case is whether the Department correctly computed the late payment penalty and the late filing penalty with respect to the taxpayers’ IL-1040’s for tax years ending December 31, 1989, 1990, 1991 and 1994. Taxpayers agree to the determinations made on the Amended Notices of Deficiency except for the following: taxpayers contest the late payment penalty of \$8,717 for 1989, the late payment penalty of \$35,243 for 1990, the late payment penalty of \$407 for 1991 and the late filing or nonfiling penalty of \$5,444 for 1994. The issue with regard to the penalties is whether the additional income tax assessed to the taxpayers from federal audit adjustments should be

reduced by net operating loss carrybacks before the computation of the late payment and late filing penalties.

Pursuant to The Illinois Income Tax Act, 35 ILCS 5/101 *et seq.*, a late payment penalty will be imposed if the tax that is due for any return is not paid on the due date of the return. 35 ILCS 5/1005. The Department applied the provisions of Section 1005 to compute the late payment penalty for tax years 1989, 1990 and 1991. For tax years ending on or before January 1, 1994, a late payment penalty was appropriate:

If an 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 underpayment unless it is shown that such failure is due to reasonable cause. This penalty shall be in addition to any other penalty determined under the Act.  
35 ILCS 5/1005(a) (applicable before Jan. 1, 1994)

For 1989, John's AGI increased by \$1,947,687. The tax payable on this increase at 2.75% was \$53,562. The late payment penalty of \$8,717 was computed at 6% of \$53,562 for 990 days, from April 15, 1990, the due date of the 1989 return (see 35 ILCS 5/505(a)(2)), through December 31, 1992. On December 31, 1992, a loss carryback from 1992 eliminated the tax payable. The tax of \$53,562 was unpaid for 990 days.

For 1990, John's AGI increased by \$8,415,694. The tax payable on this increase at 3% was \$252,471. A late payment penalty of \$25,980 was computed at 6% of \$252,471 for 626 days, from April 15, 1991, the due date of the 1990 return (see 35 ILCS 5/505(a)(2)), through December 31, 1992. On December 31, 1992, a loss carryback of \$96,477 from 1992 reduced the tax payable to \$156,024. The tax of \$252,471 was unpaid for 626 days. On December 31, 1992, \$156,024 (\$252,471 minus \$96,477) in tax

remained unpaid. A late payment penalty of \$9,362 was computed at 6% of \$156,024 for 365 days, through December 31, 1993. On December 31, 1993, a loss carryback from 1993 eliminated the tax payable. The tax payable of \$156,024 was unpaid for 365 days. The total late payment penalty for 1992 was \$35,342 (\$25,980 plus \$9,362).

For 1991, John and Jane's AGI increased by \$132,170. The tax payable on this increase at 3% was \$3,965. The late payment penalty of \$407 was computed at 6% of \$3,965 for 625 days, from April 15, 1992, the due date of the 1991 return (see 35 ILCS 5/505(a)(2)), through December 31, 1993. On December 31, 1993, a loss carryback from 1993 eliminated the tax payable. The tax of \$3,965 was unpaid for 625 days.

The Department computed the late filing penalty for tax year 1994 in accordance with the provisions of 35 ILCS 5/1001, which applied to tax years ending on or after January 1, 1994, and provided in relevant part:

In case of a failure to file any return required under this Act on the date prescribed therefore, (determined with regard to any extensions of time for filing) there shall be added as a penalty the amount prescribed by Section 3-3 of the Uniform Penalty and Interest Act. 35 ILCS 5/1001 (applicable on Jan. 1, 1994)

For tax years ending on or after January 1, 1994 and before January 1, 1996, the Uniform Penalty and Interest Act ("UPIA") provides, in part, that:

A penalty of 5% of the tax required to be shown due on a return shall be imposed for failure to file the tax return on or before the due date prescribed for filing, determined with regard for any extension of time for filing. 35 ILCS 735/3-3(a) (applicable before Jan. 1, 1996)

For 1994, John's AGI increased by \$3,680,001. The tax payable on this increase at 3% was \$108,881.<sup>1</sup> The late payment penalty of \$5,444 was computed at 5% of \$108,881.<sup>2</sup> On December 31, 1997, a loss carryback from 1997 eliminated the tax payable. The "tax required to be shown due" was \$108,881, and this tax was due from October 15, 1995,<sup>3</sup> the due date of the 1994 return through December 31, 1997. John's 1994 IL-1040 was filed on October 7, 1996, approximately one year after the due date. Dept. Brief. p. 12.

It must be noted here that the taxpayers' net operating loss carrybacks were not available when the taxpayers' tax liabilities were due. The fact that the tax liabilities were eventually eliminated by operating loss carrybacks is irrelevant because those carrybacks were not available to eliminate the liabilities on the date the tax liabilities were due. By the time the operating loss carrybacks were applied, the tax liabilities for the tax years at issue had been past due for as much as 2 ½ years. For instance, the 1989 tax was due on April 15, 1990. 35 ILCS 5/505(a)(2). The 1992 net operating loss carryback that John applied to offset his 1989 tax was not available until December 31, 1992, 990 days after the tax for 1989 was due. The taxpayers did not file an IL-1040-X to establish and claim the 1992 carryback until November 14, 2003. Dept. Ex. No. 20. For tax year 1991, the tax liability, due April 15, 1992, remained unpaid until the taxpayers applied an operating loss carryback from 1993. Stip. Ex. No. 2. The net operating losses incurred by the

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<sup>1</sup> The tax payable also reflects other adjustments, not at issue in this proceeding.

<sup>2</sup> After January 1, 1994, penalties were not computed on a "per annum" basis.

<sup>3</sup> For tax years ending on or after January 1, 1994 but before January 1, 1996, the due date of the IL-1040, and therefore the tax required to be shown due on the return, was determined by including the extension of time for filing the return. 35 ILCS 735/3-3(a). The Department's regulation grants an individual taxpayer a 6-month automatic extension of time for filing his IL-1040. 86 Ill. Adm. Code § 100.5020(b). Therefore, for tax years ending on or after January 1, 1994 but before January 1, 1996, the tax required to be shown due on a return was due on or before October 15, of the year following the close of the tax year. 86 Ill. Adm. Code § 100.9320(h).

taxpayers were not available to the taxpayers for carryback at the times that the IL-1040's for the tax years at issue were due. Therefore, the penalties were appropriate because they were based on the increased tax, properly assessed from the increase in taxpayers' AGI due to the federal audit adjustments, and the increased tax was not paid on or before the applicable due dates of the tax returns.

The starting point for computing an individual taxpayer's Illinois net income is his AGI, and any change in AGI must be included in the amount the taxpayer reports on line 1 of his IL-1040. 35 ILCS 5/202 and 5/203. In the instant matter, the taxpayers' AGI increased because of the adjustments identified in the federal audits. The taxpayers were required to include the additional income identified in the federal audits in line 1 of their AGI for the tax years at issue. The tax attributable to the increase in the taxpayers' AGI should have been included in the amount of tax that was required to be shown due on the taxpayers' IL-1040 for the years at issue, and therefore should have been paid on or before the due dates for the returns.

If the taxpayers had prepared their original US-1040's correctly for the tax years at issue, the additional income identified in the federal audits would have been included in their AGI, and therefore would have been included in Line 1 of their IL-1040's for the tax years at issue. A correctly prepared IL-1040 would have shown a tax due amount that included the tax actually reported on the taxpayers' IL-1040's plus the additional tax attributable to the federal changes. The late payment penalties for 1989, 1990 and 1991 and the late filing penalty for 1994 would have been computed using the total tax required to be shown on the returns without any offset for operating loss carrybacks, which were not available when the tax returns should have been filed.

It must be further noted that 35 ILCS 5/1005(a) required that the late payment penalty be based on a percentage of the “tax underpayment” and 35 ILCS 735/3-3(a) requires that the penalty be based on a percentage of “the tax required to be shown due on a return.” The taxpayers argue that, for the years at issue, there was no tax underpayment to which the late payment penalties of Section 1005 and Section 3-3 of the UPIA could apply. “This is so because all Illinois income taxes for those years were eliminated by [net operating loss carrybacks]. That is, the [carrybacks] resulted in reductions in Illinois income taxes for the years at issue, with no net tax due for those years.” Taxpayer’s Brief, p. 8.

Taxpayers are correct that the income tax due for the years at issue was eliminated by the loss carrybacks, but this elimination occurred years after the tax was due. Late payment and late filing penalties are sanctions for not paying tax due or not filing tax returns by the due date. The phrases “tax underpayment” in 35 ILCS 5/1005(a) and “tax required to be shown due” in 35 ILCS 735/3-3(a) are not ambiguous and must be given their plain meaning. Unambiguous terms in a statute must be given their plain and ordinary meaning. People v. Pierce, 367 Ill. App. 3d 203 (2d Dist. 2007). Section 1005 states that the late payment penalty is 6% per annum, “upon the tax underpayment...” (35 ILCS 5/1005(a)) and the UPIA states that the late filing penalty is imposed on the “tax required to be shown on a return.” 35 ILCS 735/3-3(a). The express terms of these statutes do not provide for the computation of penalties after reduction of the tax liability by net operating loss carrybacks, not available at the time the tax returns are due. If the Illinois General Assembly had intended for the Department to compute penalties after applying net operating loss carrybacks not available at the time that the tax returns were

due, it would have provided for such offsets in the statute. In the absence of a provision in the statute providing for the retroactive offset of tax liability by an operating loss carryback, I must conclude that the General Assembly did not intend for the Department to make this offset before the computation of penalties.<sup>4</sup>

Case law supports the Department's calculation of the late filing and late payment penalties in the instant case.<sup>5</sup> In Bunney v. Commissioner of Internal Revenue, 114 T.C. 259 (2000), the court found that a loss carried back from a later year does not reduce a tax underpayment for purposes of computing a negligence accuracy-related penalty. In Bunney, the taxpayer claimed entitlement to a net operating loss carryback to eliminate some or all of a tax deficiency. The court found that the taxpayer was liable for the penalty even if the claimed net operating loss carryback eliminated the deficiency for the year. The court succinctly stated that “[A] loss in a later year does not reduce the underpayment for purposes of imposing the penalty.” *Id.* at 268.

In Manning v. Seeley Tube & Box Co. of New Jersey, 338 U.S. 561 (1950), the Court had to decide the issue of whether interest on a validly assessed tax deficiency for fiscal year 1941 was abated when the deficiency was eliminated by the carryback of a net operating loss for fiscal year 1943. The Court held that the subsequent cancellation of the duty to pay the assessed deficiency did not cancel the duty to pay the interest on the deficiency. *Id.* at 565. The Court noted that a taxpayer entitled to a carryback of a net

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<sup>4</sup> For tax years covered by the UPIA, the late payment penalty is based on the tax required to be shown due on a return “reduced by any part of the tax which is paid on time and by any credit which was properly allowable on the date the return was required to be filed.” 35 ILCS 735/3-3(c). It is clear that the General Assembly will include offset provisions in a statute when necessary. It is also clear, in the instant case, that net operating loss carrybacks are not credits that are “properly allowable,” because the carrybacks had not been determined, and were, in fact, years away from being determined, “on the date the return was required to be filed.”

<sup>5</sup> My research indicates that no Illinois court has addressed the facts at issue in the current matter.

operating loss will not be able to determine the deduction from such carryback until the close of the future taxable year in which he sustains the net operating loss. “He must therefore file his return and pay his tax without regard to such deduction, and must file his claim for refund at the close of the succeeding taxable year when he is able to determine the amount of such carryback.” “We can imagine no clearer indication of a Congressional understanding and intent that the carryback was not to be interpreted as deferring or delaying the prompt payment of taxes properly due.” *Id.* at 567.

Although Manning dealt with interest on a tax deficiency, the case can be compared to the issues before this tribunal. In the case at bar, the taxpayers were required to pay the taxes on the applicable due dates. When taxes were not paid or the IL-1040's were not filed by the due dates, late penalties were assessed. After the taxpayers determined that they had eliminated or overpaid their taxes because of net operating loss carrybacks, the taxpayers' course of action would have been to file a claim for refund after the loss year, the date on which they were able to determine the amount of loss available to carryback to offset income in prior years. Since the loss carrybacks were not available until the close of certain future tax years, these losses did not reduce the taxpayers' net income when the tax was due for the tax years at issue. Therefore, as seen in Manning, the net operating loss carrybacks did not reduce the taxpayers' tax liabilities until after the due dates for the tax years at issue. Accordingly, the late payment penalty and the late filing penalty were appropriately assessed.

On February 26, 1996, the Department issued Private Letter Ruling No. 96-0027. This letter ruling states that in the case of a net operating loss carryback, penalties and interest would stop accruing only after the net operating loss carryback is claimed. “In

addition, with respect to the penalties for failure to file tax returns under Section 1001 and failure to pay estimated tax under Section 804 of the Illinois Income Tax Act, we take the position that a net operating loss carryback does not offset such penalties since a net operating loss carryback is deemed as a payment rather than a reduction to tax.” Ill. Ltr. Rul. IT 96-0027 (Feb. 26, 1996). In the instant case, the Department treated taxpayers’ net operating loss carrybacks in accordance with this letter ruling. The net operating loss carrybacks were treated as a tax payment and penalties accrued on the unpaid taxes until the net operating loss was claimed.

The taxpayers argue that there is no statutory basis for treating the net operating loss carrybacks as payments instead of reductions in AGI and therefore in tax. Taxpayers’ Brief, p. 9. My research indicates that the Illinois Income Tax Act does not have a provision that states specifically when underpaid interest stops accruing on a deficiency offset by a net operating loss carryback. The Department argues in its Brief that IRC § 6601(d)(1) served as the basis for the position set forth in PLR 96-0027. IRC § 6601(a) sets forth the general rule that if any amount of tax is not paid on or before the last date prescribed for payment, the taxpayer shall pay interest on such amount for the period from such last date to the date paid. IRC § 6601(d)(1) provides that reduction of an unpaid tax by the carryback of a net operating loss does not affect the computation of interest for the period ending with the filing date for the taxable year in which the net operating loss arises. In effect, the tax is treated as paid on the filing date for the taxable year in which the net operating loss arises. McCauley v. Commissioner, T.C. Memo. 1988-431. In the instant case, the Department treated the tax deficiencies as paid on

December 31 of the year that the operating losses arose and accrued penalties on the unpaid tax until that date.

The Illinois Income Tax Act does not have a provision similar to IRC § 6601(d)(1). When there is no Illinois authority to the contrary, Section 102 of the Illinois Income Tax Act incorporates the Internal Revenue Code into the Illinois Income Tax Act. Section 102 provides that, “[E]xcept as otherwise expressly provided or clearly appearing from the context, any term used in this Act shall have the same meaning as when used in a comparable context in the United States Internal Revenue Code of 1954, or any successor law or laws relating to federal income taxes and other provisions of the statutes of the United States relating to federal income taxes as such Code, law and statutes are in effect for the taxable year.” 735 ILCS 5/102. I conclude, therefore, that there is a statutory basis for the Department’s treatment of the net operating loss carryback as a tax payment and the resultant calculation of the late payment and late filing penalties in the taxpayers’ case. To sustain the taxpayers’ argument in the instant case would be to place a premium on failing to conform diligently with the Illinois Income Tax Act by not paying taxes by the due date.

WHEREFORE, for the reasons stated above, it is my recommendation that the Amended Notices of Deficiency issued January 18, 2006 to John Doe and to John and Jane Doe be finalized as issued.

ENTER:

Kenneth J. Galvin  
Administrative Law Judge

June 9, 2008