

IT 96-36
Tax Type: INCOME TAX
Issue: Business/Non-Business (General)

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

THE DEPARTMENT OF REVENUE)		
OF THE STATE OF ILLINOIS)		
)		
)		
v.)	No.	
)	FEIN	
)	TYE	3/86 - 3/88
TAXPAYER)		
)		
Taxpayer.)		

FINAL ADMINISTRATIVE DECISION

Appearances: John B. Truskowski, Keck Mahin & Cate, for TAXPAYER Deborah Mayer, Special Assistant Attorney General, for the Department of Revenue.

Synopsis:

This matter arose after TAXPAYER (formerly TAXPAYER, and hereinafter "TAXPAYER" or "Taxpayer") protested a Notice of Deficiency ("NOD") which was issued by the Department of Revenue ("Department"). The NOD proposed to assess tax on income received by TAXPAYER during tax years ending 3/31/86 through 3/31/88.

A hearing was held in November 1991. A recommended decision was subsequently written and tendered to the (previous) Director for approval. During the time the Director was reviewing that recommended decision, the United States Supreme Court issued its decision in Allied Signal v. Director, Division of Taxation, 504 U.S. 768, 112 S.Ct. 2251, 119 L.Ed. 2d 533 (1992). Thereafter, the administrative law judge who presided at hearing notified the his superiors that the Allied Signal decision could possibly have a bearing on this matter, and requested that the recommended decision be reviewed in light of that case.

In March 1996, the parties agreed to present additional arguments regarding the effect of, *inter alia*, the Allied Signal decision on the facts and issues presented in this matter.

The parties stipulated that the only issue in this matter is whether dividends and capital gains TAXPAYER received from holding and selling Japanese bank stock were properly classified as business income apportionable to Illinois. I am therefore issuing this Final Administrative Decision, in part, to address the recent arguments of the parties. I have made a review of the record, specifically all evidence adduced at hearing, and the arguments of the parties. Included in this decision are findings of fact and conclusions of law. Upon consideration of all factors, it is my decision that the issue should be resolved in favor of the Department.¹

Findings of Fact:

Facts Regarding Taxpayer's Organization, Generally

1. TAXPAYER is a New York corporation, with its principal place of business located in New York. Stipulation ("Stip.") ¶ 3.
2. TAXPAYER is a wholly-owned subsidiary of COMPANY ("COMPANY"), a Japanese general trading company. Stip. ¶ 4; Department Ex. No. 15.
3. TAXPAYER is a trading company engaged in business in the United States. TAXPAYER trades a variety of products, including foodstuffs, raw materials and equipment. TAXPAYER also regularly invests capital and participates in joint ventures involving financial and/or engineering project consulting and project management businesses. See Stip. ¶ 6; Department Ex. No. 15; Hearing Transcript ("Tr.") p. 38 (testimony of VP, TAXPAYER's vice-president and treasurer).

¹. For purposes of this proceeding, it is specifically conceded that the period of delay between June, 1992 and the issuance of this decision is due solely to the inaction of the Department of Revenue. See 86 Ill. Admin. Code § 210.120(b)(2) (1993). Accordingly, should the liability herein determined stand, abatement of accrued interest for this period should be granted to this taxpayer upon application to the Board of Appeals.

4. TAXPAYER has offices in Illinois, including a branch office in Chicago. Department Ex. No. 15 (unnumbered p. 19); Tr. pp. 66 (CHICAGO BRANCH ("CHICAGO BRANCH"), manager of TAXPAYER's finance department), 83 (CHGO. VP, vice-president and general manager of TAXPAYER's Chicago branch).
5. TAXPAYER's Chicago branch has two departments, one involving the importation of machinery for sale, and another involving the importation and sale of steel. Tr. p. 84 (CHGO. VP).
6. In Illinois, TAXPAYER also engages in the business of exporting grain to Japan. Department Ex. No. 15; Tr. p. 84 (CHGO. VP).
7. TAXPAYER keeps an inventory of steel and machinery in Illinois. Tr. p. 86 (CHGO. VP).
8. TAXPAYER's accounting records are kept in its Chicago office. *Id.*
9. TAXPAYER maintains bank accounts at banks located in Chicago. *Id.* p. 87.

Facts Regarding The Income At Issue

10. Taxpayer regularly purchased, held and sold Japanese bank stock at the direction of its parent during the tax years at issue. See Stip. ¶¶ 11, 15; Department Ex. No. 16; Taxpayer Ex. No. 19; Tr. pp. 16-17 (testimony of Department auditor Louis Peay ("Peay")), 66, 74 (CHICAGO BRANCH); see also, Taxpayer's Brief, pp. 3-4 (describing the frequency of TAXPAYER's purchases and sales of bank stock).
11. Each time TAXPAYER purchased Japanese bank stock, it followed the same procedures as prescribed by its parent. See Tr. pp. 48-50 (testimony of GENERAL MANAGER ("GENERAL MANAGER"), general manger of COMPANY's finance and accounting division's planning office).
12. TAXPAYER began purchasing Japanese bank stock at the direction of its parent in 1979, and continued to purchase and sell such stock throughout the audited tax years. See Taxpayer Ex. No. 19; Tr. p. 46 (GENERAL MANAGER). TAXPAYER initially began purchasing Japanese bank stock with funds contributed to it from COMPANY specifically for that purpose (see Tr.

- p. 46 (GENERAL MANAGER)), but during the audited tax years, TAXPAYER received no such capital contributions from its parent. Tr. p. 19 (Peay).
13. TAXPAYER received dividends during the period it held the Japanese bank stock, and capital gains when it sold the stock. Stip. ¶ 11.
 14. For 1986, TAXPAYER reported its total federal income as approximately 9.2 million dollars, and it received 11.4 million dollars in capital gains from selling Japanese bank stock. Department Ex. No. 8. For 1987, TAXPAYER reported income of \$45.2 million, and its capital gains from selling Japanese bank stock amounted to \$41.3 million. Department Ex. No. 9. For 1988, TAXPAYER's reported income was \$61.3 million and its capital gains were \$61.7 million. Department Ex. No. 10.
 15. TAXPAYER was instructed by its parent to use the proceeds of the sale of Japanese bank stock to pay capital gains and other taxes associated with the sales, to pay dividends to its parent, or to purchase additional stock. Tr. pp. 47-48 (GENERAL MANAGER), 65 (CHICAGO BRANCH).
 16. In the absence of parental direction, TAXPAYER's finance department's manager, CHICAGO BRANCH, exercised discretion when deciding how to use stock sale proceeds. Tr. pp. 67-68 (CHICAGO BRANCH).
 17. If TAXPAYER was not immediately directed to purchase additional Japanese bank stock with the proceeds from stock sales, TAXPAYER deposited the proceeds into its capital account, and used such proceeds to either make short-term investments, or to reduce its line of credit. Tr. pp. 67-68, 76-78, 81-82 (CHICAGO BRANCH).
 18. One of the short-term investments TAXPAYER made with its stock sale proceeds involved entering into repurchase agreements, wherein TAXPAYER purchased short-term commercial paper, with the agreement that the issuer would buy back the paper at some point in the future. See Tr. pp. 77-82 (CHICAGO BRANCH). TAXPAYER's purchase of such commercial paper required it to use large sums of capital, e.g., over \$10,000,000.00, which it would not

otherwise have available without using the stock sale proceeds. *Id.*, p. 80 (CHICAGO BRANCH).

Facts Regarding TAXPAYER's Illinois Tax Returns & the Department's Audit

19. The Department conducted an audit of TAXPAYER for tax years ending 3/31/86 through and including 3/31/88. Stip. ¶ 9.
20. On the Illinois returns TAXPAYER filed, it classified dividends it received from Japanese bank stock, and capital gains from its sales of Japanese bank stock as nonbusiness income. Stip. ¶ 11; Department Ex. Nos. 8-10 (TAXPAYER's 1986-1988 IL-1120 forms and related schedules).
21. As a result of the audit, the Department determined that such income, i.e., dividends and capital gains TAXPAYER received from Japanese bank stock, was business income. Stip. ¶¶ 12, 15.
22. On TAXPAYER's New York State tax returns, TAXPAYER claimed the income at issue as investment income. Tr. p. 101 (ACCOUNTANT ("ACCOUNTANT"), TAXPAYER's tax accountant during the years at issue).
23. The Department issued a Notice of Deficiency, which TAXPAYER timely protested. Stip. ¶¶ 13, 14.

Conclusions of Law:

Section 1501(a)(1) of the Illinois Income Tax Act ("IITA") defines business income, in pertinent part, as follows:

The term 'business income' means income arising from transactions and activities in the regular course of the taxpayer's trade or business . . . and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations

35 **ILCS** 5/1501(a)(1). Nonbusiness income is defined as "all income other than business income or compensation." 35 **ILCS** 5/1501(a)(13).

The Department's regulations additionally provide, in part:

A person's income is business income unless clearly classifiable as nonbusiness income. . . Income of any type

or class and from any source is business income if it arises from transactions and activity occurring in the regular course of trade or business operations. Accordingly, the critical element in determining whether income is 'business income' or 'nonbusiness income' is the identification of the transactions and activity which are the elements of a particular trade or business. **In general, all transactions and activity which are dependent upon or contribute to the operations of the economic enterprise as a whole will be transactions and activity arising in the regular course of a trade or business.**

86 Ill. Admin. Code § 100.3010(a) (emphasis added).

The IITA's statutory definition of business income establishes two separate and distinct tests by which income can be classified as business income: the transactional test and the functional test. Dover Corporation v. Department of Revenue, 271 Ill. App. 3d 700, 711-12, 648 N.E.2d 1089, 1097 (1st Dist. 1995). If either test is met, the income is properly classified as business income. *Id.*

The transactional test is derived from the first clause of section 1501(a)(1) (transactions and activity in the regular course of the taxpayer's trade or business). Under the transactional test, income is business income if derived from a type of business transaction in which the taxpayer regularly engages. The functional test is derived from the second clause of section 1501(a)(1) (income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations). See Dover, 271 Ill. App. 3d at 711-12, 648 N.E.2d at 1097.

Here, the transactional test is satisfied because the dividends and stock sale proceeds were earned as a direct result of TAXPAYER's regular transactions and operations undertaken on behalf of its parent. As a regular part of TAXPAYER's business, it purchased and held Japanese bank stock. It did so at the direction of its parent, because its parent was prohibited from making such purchases under Japanese law. See Taxpayer Ex. No. 21; Tr. p. 44 (GENERAL MANAGER). The stock was originally purchased using capital contributed to TAXPAYER by its parent for that specific purpose, and thereafter, with proceeds from TAXPAYER's prior sales of Japanese bank stock. See Tr. p. 47 (GENERAL

MANAGER). The sales transactions were effectuated in exactly the same manner each time. While the frequency of the transactions during the tax years at issue was not great, the transactions were regularly conducted, and they were conducted in the ordinary course of TAXPAYER's business.

I agree with the Department that TAXPAYER's purchases of Japanese bank stock were "attributable to a type of business transaction in which taxpayer regularly engaged." See Department's Brief, p. 9 (*quoting National Realty & Investment Co. v. Department of Revenue*, 144 Ill. App. 3d 541, 494 N.E.2d 924 (2d Dist. 1986)). TAXPAYER's dependence on its parent's directions regarding the stock purchases and sales supports a determination that the transactions were regular. TAXPAYER performed the instructions given by its parent, each and every time the instructions were given.

The income at issue also satisfies the functional test because TAXPAYER's acquisition, holding and sales of the Japanese bank stock constituted an integral part of its regular business operations. TAXPAYER used the stock sale proceeds by depositing them into TAXPAYER's capital accounts, and using the proceeds in its regular business operations. See Tr. p. 78 (CHICAGO BRANCH). TAXPAYER employees would independently decide whether to use the proceeds to make short-term investments, or to pay down TAXPAYER's outstanding line of credit. *Id.*, pp. 67-68. Moreover, the capital gains TAXPAYER received from its stock sales approximately equalled or exceeded TAXPAYER's total reported federal income during the tax years at issue. Department Ex. Nos. 8-10. TAXPAYER's use of such income to pay down its outstanding line of credit, to repay loans, and to make short-term investments of funds it would not otherwise have available to use, was an integral part of its regular business operations.

TAXPAYER argues that the Department's attempt to tax the income at issue here violates the Due Process Clause of the United States Constitution because no unitary business relationship existed between TAXPAYER and the Japanese banks whose stock TAXPAYER purchased held and sold. See TAXPAYER's Brief at 12, 16. In Allied Signal, Inc. v. Director, Division of Taxation, the United States

Supreme Court ruled that the Due Process Clause of the United States Constitution did not require that a unitary relationship exist between the payor and payee of income sought to be taxed by a State. 504 U.S. 768, 784-85, 112 S.Ct. 2251, 2263, 119 L.Ed. 2d 533, 550 (1992). Instead, the Supreme Court determined that the relevant unitary business inquiry focuses on the taxpayer's treatment and use of intangible assets from which income was earned, i.e., whether the transactions served an investment function or an operational function. Allied Signal, 504 U.S. at 787, 112 S.Ct. at 2263, 119 L.Ed. 2d at 552. In light of Taxpayer's constitutional objection, the inquiry here involves a consideration of objective evidence surrounding TAXPAYER's actual treatment of transactions involving the Japanese bank stock and the income derived therefrom. See *id.*, 504 U.S. at 784, 112 S.Ct. at 2262, 119 L.Ed. 2d at 550.

Based on the evidence in this matter, I conclude that TAXPAYER's purchases, holdings and sales of Japanese bank stock, and its use of the income derived therefrom, served an operational function. Investing capital was one of TAXPAYER's "businesses." Department Ex. No. 15 (TAXPAYER's sales brochure). One of TAXPAYER's regular business operations was to purchase, hold and sell Japanese bank stock as directed by its parent. Of the three purposes for which TAXPAYER was to use stock sale proceeds, one was to purchase more stock. Where the proceeds from stock sales were not immediately needed for additional purchases, TAXPAYER exercised independent authority regarding how to use such proceeds. TAXPAYER's own witnesses acknowledged that the stock sale proceeds were used to make short-term investments of otherwise idle funds available to TAXPAYER, or were used to reduce TAXPAYER's outstanding corporate debt.

Counsel for TAXPAYER also argued recently that the Cook County Circuit Court's opinion in Dover Corporation v. Department of Revenue, No. 91 L 50730 (Aug. 17, 1993),² *aff'd*, Dover Corporation v. Department of Revenue, 271 Ill.

². The Department did not appeal the decision of the Cook County Circuit Court, Judge Alexander White, finding as contrary to law the Director's determination that certain of Dover's income was business income subject to Illinois tax. Therefore, that issue was not a part of the Appellate Court's reported Dover decision.

App. 3d 700, 648 N.E.2d 1089 (1st Dist. 1995), supports its argument that the income proposed to be assessed here is nonbusiness income which Illinois may not constitutionally tax. One critical distinction between the facts in Dover and the facts of this matter, however, is that in Dover the parties agreed that the taxpayer's ownership of securities represented long-term investment of non-working capital. Dover, No. 91 L 50730, slip. op. at 13. Here, the parties do not so agree. Compare TAXPAYER's Brief, pp. 8-9 (commingling of stock sale proceeds deposited into TAXPAYER's capital accounts did not change proceeds into assets used in TAXPAYER's regular trade or business) with Department's Brief, pp. 14-15 (Japanese bank stocks were purchased with TAXPAYER's working capital, there were no capital contributions from parent during the audited tax years, the stock sale proceeds were deposited into TAXPAYER's capital account and thereafter used for TAXPAYER's short-term investment or to reduce TAXPAYER's debt), and Tr. pp. 16, 20 (Peay testified, respectively, that TAXPAYER purchased stock with its working capital, and that he reclassified income as business income because it was produced through TAXPAYER's regular transactions, and because such income was integral to TAXPAYER's business).

Even if the parties did agree on that point, however, Judge White acknowledged in his Circuit Court Dover decision that, under Allied Signal, such investments would serve an operational purpose "only if the acquisition and sale of the securities [were] part of the owner's unitary business." Dover, No. 91 L 50730, slip. op. at 13-14. Here, purchasing, holding and selling Japanese bank stock were transactions in which TAXPAYER regularly and ordinarily engaged, and the proceeds from such sales roughly equalled or exceeded TAXPAYER's reported federal taxable income during the audited tax years. TAXPAYER, the primary member of the Illinois unitary group, treated that considerable income as serving an operational function by using the proceeds in the regular course of its business operations. Contrary to TAXPAYER's argument, therefore, the Circuit Court's Dover decision actually supports a conclusion that the income derived from such regular transactions be subject to taxation, in fair

proportion, by Illinois. TAXPAYER's due process arguments, therefore, must fail.

Miscellaneous Matters

The administrative law judge identified two issues in his recommended decision. The second issue identified and discussed therein, however, had been conceded by TAXPAYER pursuant to stipulation. Stip. ¶ 15.

Finally, the Department admitted into evidence at hearing, without objection, a schedule by which it proposed to identify the correct amount of tax alleged to be due, which amount was greater than the amount identified in the NOD. Department Ex. No. 14; Tr. pp. 30-33 (testimony of XXXXX). The administrative law judge rejected the Department's proposed revision. See Recommended Decision at 4-5. I agree that the additional tax reflected in Department Ex. No. 14 should not be assessed against TAXPAYER, but not for the reason asserted by the ALJ.³ At the time the hearing was held, the method used by the Department's auditor when preparing schedules upon which the original NOD was based was, in fact, the method prescribed to be used pursuant to Department regulation. 86 Ill. Admin. Code § 100.3380(6) (formerly 86 Ill. Admin. Code § 100.3700(c)(5)(1990)). When reconsidering the proposed assessment issued in this matter, therefore, I find no reason to revise the amount of tax originally claimed to be due.

Conclusion:

The Department's Notice of Deficiency should be assessed as proposed.

Kenneth E. Zehnder, Director
Illinois Department of Revenue

KEZ:6/10/96

³. Section 908(a) of the IITA provides, in part, "If a protest is filed, the Department shall reconsider the proposed assessment and, if the taxpayer has so requested, shall grant the taxpayer or his authorized representative a hearing." 35 ILCS 5/908(a) (1994) (formerly Ill. Rev. Stat. ch. 120, ¶ 9-908(a) (1987)). The Department's duty to "reconsider the proposed assessment" includes the duty to make corrections to the amount proposed in the Notice of Deficiency, where appropriate. 35 ILCS 5/908(a); see also Rentra Liquor Dealers, Inc. v. Department of Revenue, 9 Ill. App. 3d 1063, 1071 (1st Dist. 1973).