ILLINOIS INDEPENDENT

TAX TRIBUNAL

SECURITY LIFE OF DENVER INSURANCE COMPANY, (a corporation), Petitioner, v. ILLINOIS DEPARTMENT OF REVENUE, Respondent.	)))))))))	14 TT 89 Judge Brian F. Barov

AMENDED ORDER ON SUMMARY JUDGMENT

The Petitioner, Security Life of Denver Insurance Company ("Security Life") is a wholly-owned subsidiary of ING Holdings, a United States member of the International Netherlands Group, a Dutch-based financial services conglomerate. It is the designated Illinois filing agent for a unitary business group of life insurance companies. After an audit, Security Life filed a petition challenging notices of deficiency issued to it for the 2003 and 2004 tax years. The 2003 notice of deficiency assessed additional income tax and interest. The 2004 notice of deficiency assessed additional income tax, interest and penalties.

In the initial petition, Security Life challenged the Department's method for apportioning its unitary business income, which gave rise to the tax assessment. It also complained that the assessment of interest and penalties was excessive because the audit was not timely or efficiently conducted and completed. Security Life sought a waiver or reduction of interest and penalties, as well as the reduction or reversal of the tax assessment.

Security Life filed a motion for partial summary judgment seeking only the abatement of interest and penalties. The Department responded to Security Life's summary judgment motion and filed a cross-motion for summary judgment seeking to uphold the underlying tax deficiency. While the matter was pending, Security Life paid the assessed deficiency and, thereby, converted that portion of its claim into a protest of a denial of a refund, pursuant to section 1-45(d) of the Illinois Independent Tax Tribunal Act, 35 ILCS 1010/1-45(d). However, Security Life did not respond to the Department's motion for summary judgment on the tax assessment and has abandoned its challenge to this matter.

Security Life has maintained its challenge to the assessment of interest and penalties, and the only issues remaining for decision on summary judgment are whether Security Life is entitled to an abatement or reduction of those items.

Background

On March 4, 2008, Security Life received a notice of audit initiation for income tax for the 2001-2006 tax years. In 2005, three years before the audit began, Security Life had signed a statute of limitation waiver form for the 2001 tax year. The field audit for the 2001-2006 tax years began in April 2008, and an onsite visit was conducted from May 27, 2008 through June 13, 2008. From 2008 to 2010, Security Life responded to numerous Department information document requests and continued to sign limitations' waivers.

In the course of reviewing Security Life's business operations, the Department's auditors determined that Security Life's parent corporation, ING Holdings, encompassed two distinct unitary business groups: a unitary business group made up of life insurance companies and a unitary business group made up of non-life insurance companies. Dep't Ex. 2 at 3-4; Dep't Ex. 3 at 2-3. The income of the two unitary business groups was apportioned under different provisions of the Illinois Income Tax Act ("IITA"). The life insurance group's income was apportioned under section 304(b) of the IITA, which pro rated income based on a ratio of "direct premiums written" on Illinois risk or property to direct premiums written on overall risk or property. *See* 35 ILCS 5/304(b). The income of the non-life insurance group was apportioned under section 304(a) of the IITA, which pro rated income based on the taxpayer's Illinois "total sales" to overall total sales. *See* 35 ILCS 5/304(a).

Security Life had allocated all of ING Holdings business activity, including 100% of its losses, to the life insurance group. According to audit staff, this allocation was contrary to section 1501(a)(27) of the IITA, which prohibited the combining of unitary business groups apportioned under different subsections of section 304. The auditors further determined that ING Holdings' losses should have been divided between the life insurance and non-life insurance groups. Dep't Ex. 2 at 3-4; Dep't Ex. 3 at 3.

The audit staff evaluated four different methods for apportioning ING Holdings' losses: "total assets, total income, taxable income and gross income." Dep't Ex. 2 at 5; Dep't Ex. 3 at 4-5. The total assets, total income and gross income method were all found too unreliable or distortive. The auditors decided that the best available method for apportioning ING Holdings' losses was to use a taxable income methodology. Under this methodology, ING Holdings' losses were apportioned to the life insurance group based on the ratio of the life insurance group's taxable income to the sum of the taxable income of both the life insurance and non-life insurance groups. Dep't Ex. 2 at 6; Dep't Ex. 3 at 5. On September 1, 2010, the Department provided its audit work papers to Security Life, with its proposed tax assessment based upon the taxable income method. Pet'r Mem. in Supp. of Mot. for Partial Summ. J. at ¶ 23; Pet'r Ex. 8, Entry 9-1-10.

In the meantime, in August 2010, the Illinois General Assembly established a tax amnesty program covering tax periods extending from June 30, 2002 to July 1, 2009. *See* Pub. Act 96-1435 (eff. August 16, 2010) (amending 35 ILCS 745/10). The period to make amnesty payments was open from October 1, 2010 through November 8, 2010. *Id.* Under this program, the Department would abate and not seek to collect interest or penalties on disputed tax liabilities that were paid during the open period. *See id.* Taxpayers with unpaid tax liabilities that did not participate in the amnesty program, however, would be faced with the doubling of statutory interest and penalty rates for tax liabilities found against them. *Id.*

Security Life did not participate in the amnesty program. On October 27, 2010, it sought review of the proposed audit findings by the Informal Conference Board ("ICB"). Before the ICB, Security Life argued, among other things, that ING Holdings' losses should be apportioned based on the ratio of the gross receipts of the life insurance companies to the gross receipts of all group members. Pet'r Ex. 31. On September 11, 2012, the ICB issued its decision stating that "[a]udit should use the gross receipts methodology for purposes of allocating ING's losses in accordance with IITA Section 1501(a)(27)(C)(ii)." Pet'r Ex. 33; Dep't Ex. 10. The provision referenced by the ICB, section 1501(a)(27)(C)(ii), was language added to the IITA in August 2011. *See* Pub. Act 97-507 (eff. Aug. 23, 2011) (adding 35 ILCS 5/1501(a)(27)(C)(ii)).

The ICB decision did not resolve this matter to anyone's satisfaction. "The audit staff continue[d] to believe that the comparative gross receipts method [was] neither appropriate nor equitable to the State when allocating [ ] holding company income between unitary groups." Dep't Ex. 3 at 5. Further, the audit staff expressed dissatisfaction with instructions given them for applying the gross receipts methodology. *Id.* at 5-6. Security Life insisted that that the amount of gross receipts was limited to the "gross receipts" reportable on IRS Form 1120, line 1. *See* Pet'r Ex. 46, 48; Dep't Ex. 2 at 7; Dep't Ex. 3 at 6. In order to account for the fact that some members of the non-life insurance group had substantial income, though not line 1 income, the auditors sought to include income received from all business activity in the computation of gross receipts. Dep't Ex. 3 at 6; *see also* Dep't Ex. 2 at 7.

Thus, the auditors requested additional documentation to verify the gross receipts of the two unitary business groups. Security Life claims that it cooperated with these requests, by continuing to sign statute of limitation waivers and responding to document requests until April of 2013. The auditors characterize Security Life's conduct as superficially cooperative, but disorganized and even disruptive. Dep't Ex. 2 at 12; Dep't Ex. 3 at 9. The case was complicated when a lead auditor suffered a stroke in the Spring of 2013. Dep't Mot. for Summ. J. at 22; Pet'r Mem. in Supp. of Mot. for Summ. J. at ¶ 34, 40.

The audit report for the 2003 tax year recommended assessing a late-payment penalty. *See* Dep't Ex. 2 at 13. In response to Security Life's argument that the definition of gross receipts was uncertain, and thus penalties should not be imposed, the audit staff stated that the meaning of gross receipts, while not "clearly defined in Illinois law," could be "glea[n]ed" from it. *See* Dep't Ex. 2 at 7. The 2014 tax year audit report also recommended late-payment penalties but did not include a discussion similar to that included in the 2003 audit report. *See* Dep't Ex. 3.

On February 5, 2014, the Department issued final work papers. On March 24, 2014, the Department issued the two notices of deficiency at issue in this case. Interest was imposed for both tax years, but penalties were imposed only for the 2004 tax year and not the 2003 tax year.

Analysis

As noted, Security Life has paid the taxes assessed, is no longer contesting the assessed amount, and the only issues left for decision on summary judgment are whether the interest and penalty assessments should be reduced or abated. "Summary judgment is proper where the pleadings, depositions, and admissions on file, together with the affidavits, if any, show that there is no genuine issue as to any material fact and that the moving party is entitled to a judgment as a matter of law. " *Cain v. Hamer*, 2012 IL App (1st) 112833, ¶ 11 (internal quotation marks omitted).

Interest Cannot Be Abated.

Security Life bases its claim for the reduction or abatement of interest on what it contends was the inordinate time it took to conduct and complete the audit for the 2001-2006 tax years. According to Security Life, it "acted with ordinary business care and prudence in paying its taxes and responding to the audit and has acted in good faith at all times during the audit and subsequent procedures." Pet'r Mot. for Summ. J. at ¶ 6. The Department, by contrast, did not act timely or efficiently, as the first waiver form was signed in 2005, *see* Pet'r Mem. in Supp. of

Summm. J. at ¶ 7, and it was 12 years from the time that Security Life filed the 2001 tax return—in October 2003—until the Department issued the notices of deficiency on March 24, 2015, Pet'r Reply Br. at 6. Security Life argues that because the Department unduly delayed issuing the two notices of deficiency all the while interest was accumulating, interest should be reduced or abated.

The Department challenges Security Life's version of the facts, and blames it for delaying and obstructing the Department's efforts to complete the audit. Dep't Mot. for Summ. J. at 22. But, more importantly, the Department correctly points out that the debate over audit conduct is irrelevant because audit conduct does not provide a legal basis to challenge an assessment of interest. *Id.*

Section 1003 of the Illinois Income Tax Act, 35 ILCS 5/1003, provides that interest is imposed on tax deficiencies in accordance with Section 3-2 of the Uniform Penalty and Interest Act ("UPIA"), 35 ILCS 735/3-2. Section 3-2 of the UPIA provides rates at which interest is assessed, which differ depending upon the tax year in issue, and it provides procedures for applying various tax amnesty provisions. *Id.* Section 700.220 of the Department's regulations, which sets out in more detail the procedures for assessing interest on taxes states, "[i]nterest on tax shall accrue from the due date of the tax without regard to extensions of time for filing of returns." 86 Ill. Adm. Code § 700.220(c). Nowhere in any of these provisions is there any language permitting interest to be reduced or abated due to audit conduct.

Likewise, Security Life has not cited any other statute or regulation entitling it to a reduction or abatement of interest. Nor has Security Life provided any authority supporting a judge-made remedy allowing the abatement or reduction of interest for good behavior, or otherwise. Its plea for an "equitable compromise," Pet'r Reply Br. at 6-7, is unsupported by any legal authority, legal analysis, or even a description of the elements of this novel remedy. Whether viewed as a problem of forfeiture, or simply as a failure to state a claim, Security Life's failure to provide any authority in support of its proposed remedy dooms it. *See Vine St. Clinic v.*

HealthLink, Inc., 222 Ill. 2d 276, 302 (2006); *Am. Country Ins. Co. v. Mahoney*, 203 Ill. App. 3d 453, 464 (1990).

Security Life goes on to argue that, at least, it should not have to pay the higher amnesty rate imposed because it did not participate in the 2010 amnesty. *See* Pet'r Rep. Br. at 7-8 (citing *Metro. Life Ins. Co. v. Hamer*, 2013 IL 114234). It argues that under *Metropolitan Life* it did not have to pay the amnesty rate while it was under audit because its taxes were not yet due, and thus not enforceable. *See* Pet'r Reply Br. at 8. But the *Metropolitan Life* court rejected that argument, holding that for amnesty purposes, taxes are due "at the time the initial tax return was required to be filed." *See id.* at ¶ 35. Security Life's initial tax returns were due in 2003 and 2004, and the double interest amnesty rates apply to Security Life's assessment.

Security Life is Entitled to Abate the 2004 Penalties.

To the extent that Security Life also bases its claim for reduction or abatement of 2004 tax-year penalties on purported audit delays, this claim fails for the same reason as did its claim for the reduction or abatement of interest. Security Life has not provided any authority to support its argument that the length of the audit is a basis for penalty relief.

Yet, Security Life's claim fares better for another reason. Section 3-8 of the Uniform Penalty and Interest Act, 35 ILCS 735/3-8, provides that tax penalties may be abated "if the taxpayer shows that his failure to file a return or pay tax at the required time was due to reasonable cause." Further, "[r]easonable cause shall be determined in each situation in accordance with the rules and regulations promulgated by the Department." *Id.* Under the Department's regulations, reasonable cause is measured by the taxpayer's good faith in determining its tax liability, and good faith is based on whether the taxpayer "exercised ordinary business care and prudence in doing so." 86 Ill. Adm. Code § 700.400(c). Ordinary business care and prudence is "a factual determination that can be decided only on a case by case basis," *Kroger Co. v. Dep't of Revenue*, 284 Ill. App. 3d 473, 484 (1st Dist. 1996), but is in large part a function of "the clarity of the law or its interpretation and the taxpayer's experience, knowledge and education," 86 Ill. Adm. Code § 700.400.

Under the applicable standard, penalties are properly imposed when a taxpayer willfully neglects clear statutory or judicial authority. *See PPG Indus. Inc. v. Dep't of Revenue*, 328 Ill. App. 3d 16, 26 (1st Dist. 2002); *Kroger Co.*, 284 Ill. App. 3d at 484. Penalties are not imposed where a taxpayer is unable to ascertain a clear legal standard through no fault of its own. *See Du Mont Ventilation Co. v. Dep't of Revenue*, 99 Ill. App. 3d 263, 266 (3d Dist. 1981).

The dispute below centered on whether the term "gross receipts" was clearly defined under Illinois law. Security Life expends considerable effort arguing that the definition was not clear and its interpretation of the term "gross receipts" was reasonable given the complexity of the federal tax treatment of insurance companies. Pet'r Reply Br. 2-5. But this argument misses the mark. The Department did not base its penalty assessment on the dispute over the gross receipts methodology's application (which came to a head in the wake of the 2012 ICB decision). Rather, it imposed late payment penalties as an outgrowth of the 2004 decision to allocate all of ING Holdings' losses to the life insurance business group, rather than split the income between the life insurance and non-life insurance groups. Dep't Mot. for Summ. J. at 2, 20.

The Department asserts that allocating all of a holding company's income to single unitary business group in 2004 was contrary to its "long-standing policy." *Id.* at 20. But it offers no statute, case law, regulation or any other type of interpretive document to show this policy's existence.

In 2004, when ING Holdings' losses were allocated to Security Life's unitary business group, section 1501(a)(27) of the IITA stated:

> In no event . . . will any unitary business group include members which are ordinarily required to apportion business income under different subsections of Section 304 except that for tax years ending on or after December 31, 1987 this prohibition shall not apply to a unitary business group composed of one or more taxpayers all of which apportion business income pursuant to subsection (b) of Section 304, and a holding company of such single-factor taxpayers.

See Pub. Act 92-846 (codified at 35 ILCS 5/1501(a)(27)). Thus, in 2004, section 1501(a)(27) made clear that a holding company of insurance companies could be combined with unitary business group of insurance companies.

Section 1501(a)(27) went on to say:

> If a unitary business group would, but for the preceding sentence, include members that are ordinarily required to apportion business income under different subsections of Section 304, then for each subsection of Section 304 for which there are two or more members, there shall be a separate unitary business group composed of such members.

Id. Thus, section 1501(a)(27) also made clear that companies that apportion income under section 304(a) and section 304(b) had to be included in different unitary business groups. But, in 2004, section 1501(a)(27) did not provide any direction on whether or how a holding company income of insurance and non-insurance companies should apportion its income between unitary business groups.

The trial court and administrative decisions existing in 2004 are not helpful. The few existing decisions are limited to defining a holding company in the context of including that holding company in a unitary group. They do not provide direction on how to apportion income between two unitary groups, particularly not those that file under different subsections of section 304. *See Cincinnati Cas. Co. v. Bower,* 00 L 50254 (Jan. 1, 2001) (discussing *Shaklee v. Dep't of Revenue,* No. 93 L 50530 (Sept. 25, 1996), *aff'd,* 298 Ill. App. 3d 1165 (1998)); *see also* "*Aldtritch Casualty Company*," Ill. Dep't of Revenue, No. 99 IT 20 (Nov. 5, 1999).[1]

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[1] *Aldritch Casualty Company* did involve income apportionment between an insurance and noninsurance group based on a gross receipts, although the matter was not in issue. Moreover, both Security Life and the Department refer to a case identified in the record as *Department of Revenue v Aldrich Casualty Co.*, No. 95 IT 0252. *See* Dep't Ex. 3 at 4. According to Security Life this case held that non-insurance holding companies should be included in the unitary business of its subsidiaries. Pet'r Ex 12. The Department asserted the decision addressed only the

The Department's case for a "long-standing policy" of apportioning holding company income among the differing unitary business groups is further undermined by the extensive internal disagreement over the appropriate methodology for doing so seen in the auditor's narrative. Before the ICB decision, the audit staff discussed four different methods of apportionment and rejected a "gross income" method before settling on a taxable income method. Dep't Ex. 2 at 5; Dep't Ex. 3 at 4-5. After the ICB directed audit to allocate income based on a gross receipts method, the audit staff remained critical of this methodology and uncertain of how to apply it. Dep't Ex. 3 at 5.

Nor can it be ignored the Department did not include a penalty assessment for the 2003 tax year, even though Security Life took the same filing petition and penalties were recommend by the audit staff. While the failure to assess penalties in 2003 did not estop the Department from correcting such an error, if Security Life's filing position in 2004 was unreasonable, s*ee Brown's Furniture Co. v. Wagner*, 171 Ill. 2d 410, 432-33 (1996), it further supports the lack of consensus on how Security Life should have allocated ING Holdings' losses.

It was not until 2011 that section 1501(a)(27)(C)(ii) was amended to provide a mandate and methodology for apportioning a holding company's income between multiple unitary business groups. The new legislation stated:

> (ii) The income of a holding company which is a member of more than one unitary business group shall be included in each unitary business group of which it is a member on a pro rata basis, by including in each unitary business group that portion of the base income of the holding company that bears the same proportion to the total base income of the holding company as the gross receipts of the unitary business group bears to the combined gross receipts of all unitary business groups (in both cases without regard to the holding company) or on any other reasonable basis, consistently applied.

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definition of holding company and was later reversed by the circuit court. Dep't Ex. 3 at 4. The decision was not provided to the Tribunal and my own research did not uncover it. It is not clear if the 1995 *Aldrich* case is the same as the 1999 *Aldritch* decision, but, under the circumstances, neither can be deemed to provide reliable guidance for taxpayers on how to allocate a holding companies' income between insurance and non-insurance unitary business groups in 2004.

Pub. Act 97-507 (adding 35 ILCS 1501(a)(C)(ii)).

This is the language that the ICB referenced in its 2012 decision. But eight years earlier, in 2004, it is hard to see how "ordinary business care and prudence" would counsel Security Life to pro rate ING Holdings' losses between the two unitary groups with no legal guidance and the considerable uncertainty within the Department on how to do so. Security Life did not willfully neglect clear law in allocating all of ING Holdings' income to Pacific Life's unitary business group, and the assessment of penalties should be vacated. *See PPG Indus., Inc.*, 328 Ill App 3d at 25-26; *Du Mont Ventilation Co.*, 99 Ill. App. 3d at 266.

Conclusion

The Department's motion for summary judgment on the denial of Security Life's claim for a refund of the tax assessed is GRANTED. The notice of claim denial for the amount of tax assessed is affirmed.

Security Life's motion for summary judgment on the assessment of interest is DENIED and the 2003 and 2004 notices of deficiency assessing interest are affirmed. Security Life's motion for summary judgment on the penalty assessment is GRANTED and the 2004 notice of deficiency penalty assessment is reversed and vacated.

This is a final order subject to appeal under section 3-113 of the Administrative Review Law, and service by email is service under section 3-113(a). *See* 35 ILCS 1010/1-90; 86 Ill. Adm. Code § 5000.330. The Tribunal is a necessary party to any appeal.

s/ *Brian Barov*
BRIAN F. BAROV
Administrative Law Judge

Date: June 27, 2016