IT 99-7
Tax Type: Income Tax
Issue: Federal Change (Individual)

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

THE DEPARTMENT OF REVENUE OF THE STATE OF ILLINOIS	**NO. 98-IT-0000**
	SSN: 000-00-0000
V.	**TAX YEAR 1991**
"JOHN D. DOE" TAXPAYER	**KENNETH J. GALVIN ADMINISTRATIVE LAW JUDGE**

RECOMMENDATION FOR DISPOSITION

SYNOPSIS:

The Illinois Department of Revenue (hereinafter "the Department") issued a Notice of Deficiency (hereinafter "NOD") to "John D. Doe" (hereinafter "taxpayer") for the 1991 tax year. The basis of the NOD was the Department's determination that taxpayer had failed to report to the Department an adjusted gross income (hereinafter "AGI") of $170,694, as taken from a transcript of the Taxpayer's federal tax account. The NOD proposed the assessment of taxes, penalties and interest for 1991.

Taxpayer filed a timely protest of the NOD and subsequently waived his right to a hearing and requested that the matter be decided based on written submissions only. The taxpayer and the Department stipulated to certain facts. Both parties filed "Initial Briefs" and the Department filed a "Reply Brief." After carefully reviewing the documentation in

the file, the briefs submitted by the parties and the relevant law, I recommend that the NOD be finalized as issued.

FINDINGS OF FACT:

1. On November 19, 1996, the Department issued a NOD to the taxpayer. The Department's *prima facie* case, inclusive of all jurisdictional elements, is established by this NOD, which shows an income tax deficiency of $5,091, penalties of $4,044 and interest of $2,032 calculated through the date of the NOD, based on Taxpayer's federal reported AGI of $170,694. Dept. Ex. No. 1.
2. On January 15, 1997, taxpayer protested the NOD, stating in his protest that he did not have income of $170,000 in 1991. Taxpayer's Ex. No. 1.
3. On or about March 23, 1992, the taxpayer filed his 1991 U.S. Individual Income Tax Return on Form 1040 (hereinafter the "original return"). (Stip. ¶ 2).
4. Prior to filing the original return, the taxpayer was a victim of an investment scheme designed by "Arbuthnot and Associates", in which the taxpayer was induced to purchase real estate tax shelters which were ultimately determined to be worthless. (Stip. ¶ 3).
5. In order to purchase the "Arbuthnot" investments, the taxpayer borrowed funds from a commercial lender, signed a promissory note agreeing to repay the funds, and hypothecated his interest in certain United Parcel Service common stock as security for the note. When the "Arbuthnot" investments became worthless, the taxpayer defaulted on the note and the bank foreclosed on the hypothecated common stock. (Initial Brief of Taxpayer, p. 2).

6. The taxpayer's original return was reviewed by the Internal Revenue Service (hereinafter "IRS"), with regard to taxpayer's treatment of the transaction involving the hypothecation of United Parcel Service common stock and the investment in real estate tax shelters with "Arbuthnot". (Stip. ¶ 4).

7. The IRS recommended that the taxpayer amend his 1991 return. Taxpayer engaged H&R Block to provide professional income tax advice and file the amended income tax return. H&R Block advised the taxpayer that his 1991 federal income tax return should be amended to recognize the income tax gain and loss associated with the common stock and the real estate investment transaction. H&R Block subsequently prepared, reviewed and submitted taxpayer's amended U.S. Individual Income Tax Return on Form 1040X for tax year 1991 (hereinafter the "amended return"). (Stip. ¶ 5, 6 and 7).

8. The amended return reflects an increase in taxpayer's AGI of $115,802. This increase represents a capital gain on the conversion of taxpayer's United Parcel Service common stock. This gain was not included on taxpayer's original return. (Stip. ¶ 8).

9. The amended return also reflects an increase in taxpayer's itemized deductions on Schedule A of $128,128. This increase in itemized deductions represents the taxpayer's loss on the purchase of the worthless real estate investments sold by "Arbuthnot". The loss was characterized as a casualty/theft loss and reported as an itemized deduction on Schedule A rather than as a capital loss reported on Schedule D. This loss was not included on taxpayer's original return. (Stip. ¶ 9 and 10).

10. On March 25, 1999, taxpayer waived his right to a hearing and requested that the matter be decided on written submissions only. Taxpayer's Ex. No. 2.

Conclusions of Law:

The Illinois Income tax Act (hereinafter "the Act") defines an individual taxpayer's "base income" as an amount equal to the taxpayer's adjusted gross income for the taxable year. 35 ILCS 5/203 (a)(1). Further, the Act defines a taxpayer's adjusted gross income as the amount of adjusted gross income "properly reportable" for federal income tax purposes under the provisions of the Internal Revenue Code. 35 ILCS 5/203 (e). Taxpayer interprets the phrase "properly reportable" as indicating that the Department should look "beyond the Taxpayer's federal return as filed and determine AGI based not upon the amount actually reported, but upon the amounts that are properly reportable."

According to the taxpayer, H&R Block's characterization of the worthless "Arbuthnot" investments as a casualty/theft loss included in itemized deductions on Schedule A was improper. The taxpayer maintains that the proper treatment for the loss would have been to characterize the loss as a capital loss from either a worthless security or a nonbusiness bad debt, included on Schedule D. If the transaction had been reported as a capital loss either from a worthless security or a nonbusiness bad debt, the amount of the loss ($128,128) would have been offset against the gain from the conversion of the taxpayer's United Parcel Service common stock ($115,802) in his federal AGI, resulting in a corresponding decrease in his Illinois AGI. In contrast, treatment of the loss as a casualty/theft loss included in itemized deductions on the federal return has no effect on taxpayer's Illinois AGI. The taxpayer maintains that the Department should look beyond

the amount that was "actually reported" to the IRS, where the loss was included as an itemized deduction, and instead look to what was "properly reportable" to the IRS, with the loss treated as a capital loss. The taxpayer cites no authority for his position.

The Department maintains that the phrase "properly reportable" in 35 ILCS 5/203(e) is synonymous with "actually reported" and cites Caterpillar Tractor Co. v. Lenckos, et al., 84 Ill.2d 102 (1981) in which the Illinois Supreme Court affirmed the Third District's opinion in Caterpillar Tractor Co. v. Lenckos, et al., 77 Ill.App.3d 90 (1979) (hereinafter "Lenckos"). In Lenckos, Caterpillar Tractor had two options on its federal return for reporting taxes paid to foreign governments. The first option consisted of an "above the line" deduction, which would have resulted in a reduction of the taxable income reported for federal purposes and accordingly, a reduction in Illinois taxable income. The second option involved reporting additional "hypothetical" income and a corresponding "below the line" credit. This option would increase taxable income for federal and Illinois purposes, but the "below the line" credit would have no effect on Illinois taxes.

Caterpillar Tractor chose the second option, but argued that because it could have properly chosen instead to take a deduction that would have reduced taxable income, the "properly reportable" language in the statute allowed Illinois income tax to be assessed on the lower federal taxable income figure. The Court rejected Caterpillar's argument and stated that the Illinois statute clearly expresses a legislative intent that taxable income for Illinois income tax purposes is the taxable income arrived at for federal tax purposes as long as the method employed to compute taxable income for federal purposes was proper under the Internal Revenue Code. Caterpillar, 77 Ill.App.3d at 102.

On July 21, 1993, the taxpayer in the instant case executed a written agreement with the Internal Revenue Service in which the Federal income tax consequences of taxpayer's dealings with "Arbuthnot" were determined. The agreement states in part: "NOW, IT IS HEREBY DETERMINED AND AGREED, for federal income tax purposes that taxpayer(s) realized a theft loss deductible under IRC section 165(c)(3)." Theft losses are reported as itemized deductions on line 19 of Schedule A, and the taxpayer complied with the IRS agreement and included the theft loss as an itemized deduction on his federal return.

Assuming *arguendo*, that the taxpayer had the option of reporting the loss as a capital loss, but chose instead to include it as an itemized deduction, the taxpayer would be bound by his alternative election, as long as the election does not violate the Internal Revenue Code. In Lenckos, the court found that Caterpillar was bound by the election it made for federal income tax purposes and stated: "Nothing in our existing Illinois law can be found to relieve the plaintiffs of the consequences of their choices for Illinois income tax purposes." Caterpillar, 77 Ill. App. 3d at 102.

The taxpayer in the instant matter entered into an agreement with the Internal Revenue Service in which he was required to characterize his theft loss as an itemized deduction. He is now bound by that characterization for Illinois income tax purposes. Accordingly, it is recommended that the Notice of Deficiency be finalized as issued.

ENTER:

_____

Kenneth J. Galvin
Administrative Law Judge

October 15, 1999