

**ILLINOIS INDEPENDENT TAX TRIBUNAL
CHICAGO, ILLINOIS**

SWAGELOK COMPANY,)	
Petitioner)	
)	
v.)	15-TT-128
)	
ILLINOIS DEPARTMENT OF REVENUE,)	
Respondent)	

ANSWER

NOW COMES the Department of Revenue of the State of Illinois (the “Department”), through its attorney, Lisa Madigan, Attorney General of and for the State of Illinois, and for its Answer to Swagelok Company’s (“Taxpayer”) Petition of the Taxpayer, filed June 24, 2015 (the “Petition”), respectfully pleads as follows:

Jurisdiction and Venue

1. This timely petition involves a Notice of Deficiency that assesses an amount in excess of \$15,000.00 in tax, penalty, and interest under a tax law identified in Section 1-45 of the Tax Tribunal Act. Therefore, the Tax Tribunal has jurisdiction over this petition.

ANSWER: The Department admits the statements contained in Paragraph 1.

2. Swagelok accepts the Tax Tribunal’s designation of its office in Cook County to conduct the hearing in this matter.

ANSWER: The Department admits the statement contained in Paragraph 2.

Facts Common to All Counts

The Parties

3. Swagelok Corporation is a corporation maintaining its principal office at 6262 Cochran Road, Solon, Ohio 44139. Swagelok’s Taxpayer Account ID is 34-0688825.

ANSWER: The Department admits the statements contained in Paragraph 3.

4. Swagelok is a global developer and provider of high-quality and reliable fluid system solutions including products, assemblies and services for the research, instrumentation, process, oil and gas, power, petrochemical, alternative fuels, and semiconductor industries.

ANSWER: The Department admits that the Taxpayer is a major developer and provider of fluid system solutions including products, assemblies, and services, and that the Taxpayer manufactures tube fittings, valves, regulators, hoses, and other products for industries such as power generation, oil and gas production, chemical processing, biopharmaceutical, research, and semiconductor manufacturing. The Department denies the remaining statements contained in Paragraph 4.

5. The Illinois Department of Revenue is an executive agency, authorized, among other functions, to administer and enforce the provisions of the Illinois Income Tax Act. 35 ILCS 5/101 *et seq.*

ANSWER: The Department admits the statements contained in Paragraph 5.

The Illinois Income Tax Act and Business Income

6. The Illinois Income Tax Act imposes a tax on the net income of every individual, corporation, trust, and estate for the privilege of earning or receiving income in or as a resident of Illinois. 35 ILCS 5/101 *et seq.*

ANSWER: The Department admits the statements contained in Paragraph 6. The statutes speak for themselves.

7. As of July 30, 2004, the term “business income” means all income that may be treated as apportionable business income under the Constitution of the United States. 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 term “compensation” means wages, salaries, commissions, and any other form of remuneration paid to employees for personal services. 35 ILCS 5/1501(a)(3).

ANSWER: The Department admits the statements contained in Paragraph 7. The statutes speak for themselves.

Pertinent Illinois Income Tax Regulations

8. “Rental income from real and tangible property is business income if the property with respect to which the rental income was received is used in the person's trade or business or is attendant to it.” 86 Ill. Admin. 100.1030(c)(2).

ANSWER: The Department assumes that “86 Ill. Admin. 100.1030(c)(2)” was intended to be “86 Ill. Admin. 100.3010(c)(2),” and on such basis admits the statements contained in Paragraph 8. The regulation speaks for itself.

9. “Gain or loss from the sale, exchange or other disposition of real or tangible personal property constitutes business income if the property, while owned by the person, was used in its trade or business.” 86 Ill. Admin. 100.1030(c)(3).

ANSWER: The Department assumes that “86 Ill. Admin. 100.1030(c)(3)” was intended to be “86 Ill. Admin. 100.3010(c)(3),” and on such basis admits the statements contained in Paragraph 9. The regulation speaks for itself.

10. “Interest income is business income where the intangible with respect to which the interest was received, is held or was created in the regular course of the person's trade or business operations or where the purpose for acquiring or holding the intangible is related or attendant to such trade or business operations.” 86 Ill. Admin. 100.1030(c)(4).

ANSWER: The Department assumes that “86 Ill. Admin. 100.1030(c)(4)” was intended to be “86 Ill. Admin. 100.3010(c)(4),” and on such basis admits the statements contained in Paragraph 10. The regulation speaks for itself.

11. “Dividends are business income where the stock with respect to which the dividends are received, is held or was acquired in the regular course of the person's trade or business operations or where the purpose for acquiring or holding the stock is related or attendant to such trade or business operations.” 86 Ill. Admin. 100.1030(c)(5).

ANSWER: The Department assumes that “86 Ill. Admin. 100.1030(c)(5)” was intended to be “86 Ill. Admin. 100.3010(c)(5),” and on such basis admits the statements contained in Paragraph 11. The regulation speaks for itself.

The Department’s Audit

12. The Department’s audit staff and management requested and received access to Swagelok’s books and records supporting its Illinois state tax returns.

ANSWER: The Department denies the statements contained in Paragraph 12.

13. The Department’s audit of Swagelok included the taxable periods ending December 2006, December 2007, December 2008, and December 2009 (the “years at issue”).

ANSWER: The Department admits the statements contained in Paragraph 13.

14. On April 28, 2014, the Department issued Swagelok Notices of Deficiency for the following tax periods: January 2006 through December 2006, imposing an additional liability due of \$16,171.54; January 2007 through December 2007, imposing an additional liability due of \$10,134.00; January 2008 through December 2008, imposing an additional liability due of \$37,585.84; and January 2009 through December 2009, imposing an additional liability due of \$28,180.18. Therefore, the total deficiency

asserted for the period January 2006 – December 2009 was \$92,071.56. Copies of the Notice of Deficiency are attached hereto as **Exhibit 1**.

ANSWER: Copies of the Notices of Deficiency issued by the Department to the Taxpayer, for the tax years ending December 2006, December 2007, December 2008, and December 2009, dated April 28, 2015, attached to the Petition as Exhibit “1” (the “Notices”), are not material allegations of fact, and therefore do not require an answer pursuant to Illinois Independent Tax Tribunal Regulation (“Rule”) 310(b)(2) (86 Ill. Adm. Code 5000.310(b)(2)), but to the extent an answer is required, the Department admits issuing the Notices and states that the Notices speak for themselves. The Department admits the remaining statements contained in Paragraph 14.

15. These Deficiencies resulted from the Auditor’s assertion that certain items of nonbusiness income on Swagelok’s income tax returns for the years at issue should have been considered business income. Specifically, the changes were: (i) the Auditor’s reclassification of interest income as business income for the years at issue; (ii) the Auditor’s reclassification of rental income as business income for years ending December 2006, December 2008, and December 2009; (iii) the Auditor’s reclassification of capital gains from the sale of property as business income for the years at issue; and (iv) the Auditor’s reclassification of dividends as business income for years ending December 2006 and December 2007. These adjustments can be found on Schedule EDA-27 of the Notice of Deficiency, contained in the attached **Exhibit 1**.

ANSWER: The Department objects to Paragraph 15 in that it is vague and ambiguous as to the term “Deficiencies.” Notwithstanding said objection, and without waiving the same, the Department admits that the liabilities reflected in the Notices resulted, in part,

from the changes described in the second sentence of Paragraph 15, and that the adjustments corresponding to such changes can be found on the Schedule EDA-27 contained in Exhibit 1 to the Petition. The Department denies the remaining statements contained in Paragraph 15.

16. For tax years ending December 2006, December 2008, and December 2009, the Auditor proposed additional late payment penalties because Swagelok “did not pay the amount shown due on the Form IL-870, Waiver of Restrictions, within 30 days after the ‘Date of Issuance’ shown on the form.”

ANSWER: The Department admits the statements contained in Paragraph 16.

COUNT I

Swagelok Lacked Nexus with Illinois During the Years at Issue

17. Swagelok incorporates by this reference and realleges paragraphs 1 through 16 as though fully-set forth herein.

ANSWER: The Department incorporates and repeats its answers to Paragraph 1 through 16 as if fully set forth herein.

18. Swagelok is based in Solon, Ohio. Swagelok did not operate or do business in Illinois during the years at issue.

ANSWER: The Department denies the statements contained in Paragraph 18.

19. Swagelok did not own or lease any real or personal property located in Illinois during the years at issue.

ANSWER: The Department denies the statements contained in Paragraph 19.

20. Swagelok did not maintain an office or other business location in Illinois, nor did it have employees stationed in Illinois, during the years at issue.

ANSWER: The Department lacks sufficient knowledge or information to form a belief as to the truth or falsity of the statements contained in Paragraph 20.

21. Swagelok's only connection with Illinois during the years at issue was its indirect and passive ownership as a limited partner of a 0.41% interest in a partnership called Fox Pointe Apartment, L.P. ("Fox Pointe"), which owned real property in Illinois.

ANSWER: The Department denies the statements contained in Paragraph 21.

22. More specifically, Swagelok owned a 2.75% interest as a limited partner in a partnership called "McDonald Corporate Tax Credit Fund – 1994" ("McDonald Fund"). The McDonald Fund did not, by its own operations, have nexus in Illinois. The McDonald Fund purchased a 14.74% share in the Fox Pointe partnership. As a limited partner, Swagelok had no control over the McDonald Fund's investment choices. Due to this purchase, it can be said that Swagelok had a passive, indirect 0.41% ownership interest in Fox Pointe (2.75% of 14.74% is 0.41%).

ANSWER: The Department lacks sufficient knowledge or information with respect to the McDonald Fund, its operations and Swagelok's control over the fund necessary to form a belief as to the truth or falsity of the statements contained in Paragraph 22. Additionally, Paragraph 22 contains legal conclusions, not material allegations of fact, and therefore no response is required pursuant to Rule 310(b)(2).

23. The Due Process Clause of the U.S. Constitution "requires some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax and that the income attributed to the State for tax purposes must be rationally related to values connected with the taxing State." *Quill v. North Dakota*, 504 U.S. 298, 306 (1992) (internal citations omitted). The Commerce Clause of the U.S. Constitution

requires a “substantial nexus” between a taxpayer and a taxing state. *See Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977). The Supreme Court interpreted “substantial nexus” to mean a physical presence in the State in the most recent nexus case. *See Quill*, 504 U.S. at 309–20. As explicitly noted in 86 Ill. Admin. Code 100.9720(e), “[c]ontrolling decisions that assert protections afforded by the Interstate Commerce Clause, the Foreign Commerce Clause and the Due Process Clause are accepted by [Illinois] as limitations on the reach of its income tax and personal property tax replacement income tax statutes.”

ANSWER: Paragraph 23 contains legal conclusions, not material allegations of fact, and therefore does not require an answer pursuant to Rule 310(b)(2).

24. A passive, 0.41% limited partnership interest, held indirectly, is too attenuated of a connection to create nexus under U.S. constitutional principles. Lacking any other connection to Illinois, Swagelok did not have nexus with Illinois during the years at issue.

ANSWER: Paragraph 24 contains legal conclusions, not material allegations of fact, and therefore does not require an answer pursuant to Rule 310(b)(2).

WHEREFORE, the Department prays that this Tribunal enter an Order that:

- a. denies each prayer for relief contained in Count I of the Taxpayer’s Petition;
- b. finds the Notices of Deficiency are correct as issued;
- c. orders judgment in favor of the Department and against the Taxpayer; and
- d. grants any further relief this Tribunal deems just and appropriate.

Count II

In the Alternative, Swagelok's Investment Income was Nonbusiness Income for Illinois Income Tax Purposes During the Years at Issue

25. Swagelok incorporates by this reference and realleges paragraphs 1 through 24 as though fully-set forth herein.

ANSWER: The Department incorporates and repeats its answers to Paragraphs 1 through 24 as if fully set forth herein.

26. Though Swagelok believes it did not have nexus during the years at issue, it presents Count II in the alternative should Swagelok be found taxable in Illinois.

ANSWER: The Department denies the statements contained in Paragraph 26.

27. Swagelok is not engaged in the trade or business of investing.

ANSWER: The Department lacks sufficient knowledge or information to form a belief as to the truth or falsity of the statements contained in Paragraph 27.

28. During the years at issue, Swagelok invested excess cash not required for business operations in various short-term and long-term investments in order to earn a return for Swagelok's shareholders (the "Portfolio Investments"). Swagelok's Portfolio Investments consisted of securities acquired and held for purposes unrelated to Swagelok's trade or business operations.

ANSWER: The Department denies the statements contained in Paragraph 28.

29. The Portfolio Investments were held in segregated accounts which were apart from, and did not contain, operating funds. Swagelok engaged independent professional investment firms to make daily and transactional investment decisions based on investment policies during the years at issue.

ANSWER: The Department lacks sufficient knowledge or information to form a belief as to the truth or falsity of the statements contained in Paragraph 29.

30. Neither the accounts holding the Portfolio Investments nor the independent professional investment firms were located in Illinois.

ANSWER: The Department lacks sufficient knowledge or information to form a belief as to the truth or falsity of the statements contained in Paragraph 30.

31. The Portfolio Investments generated passive income in the form of interest, rent, capital gains, and dividends. Swagelok classified this income as nonbusiness income on its Illinois income tax returns for the years at issue.

ANSWER: The Department denies the statement contained in Paragraph 31 with respect to the “Portfolio Investments generated passive income.” The Department also denies that the Portfolio Investments, as defined in Paragraph 28, consisted of “excess cash not required for business operations.” The Department admits that the income referenced in Paragraph 31 was classified as nonbusiness income on the Taxpayer’s Illinois income tax returns for the years at issue.

32. Swagelok also held a 2.75% interest in a real estate partnership named McDonald Fund. Swagelok held this interest as a passive investment and Swagelok had no role and played no part in managing the partnership’s operations.

ANSWER: The Department lacks sufficient knowledge or information to form a belief as to the truth or falsity of the statements contained in Paragraph 32.

33. Swagelok did not hold or use the investment income generated by the McDonald Fund for its own working capital purposes.

ANSWER: The Department denies the statements contained in Paragraph 33.

34. The Department's Auditor asserted that certain nonbusiness income derived from Swagelok's Portfolio Investments and its investment in the McDonald Fund in the form of interest, rent, capital gains, and dividends should be classified as business income.

ANSWER: The Department denies that the Portfolio Investments, as defined in Paragraph 28, consisted of "excess cash not required for business operations." The Department admits the remaining statements contained in Paragraph 34.

35. Business income is strictly limited to income that may be treated as apportionable under the U.S. Constitution. 35 ILCS § 5/1501(a)(1).

ANSWER: Paragraph 35 contains a legal conclusion, not a material allegation of fact, and therefore does not require an answer pursuant to Rule 310(b)(2).

36. An item of income is apportionable under the U.S. Constitution if it is derived from a unitary business. *See Mobil Oil Corp. v. Comm'r*, 445 U.S. 425, 438 (1980) ("The linchpin of apportionability in the field of state income taxation is the unitary business principle.").

ANSWER: Paragraph 36 contains a legal conclusion, not a material allegation of fact, and therefore does not require an answer pursuant to Rule 310(b)(2).

37. To determine whether an entity is part of a unitary business, one looks for sufficient functional integration, centralization of management, and economies of scale with the rest of the business. *Mobil*, 445 U.S. at 438.

ANSWER: Paragraph 37 contains a legal conclusion, not a material allegation of fact, and therefore does not require an answer pursuant to Rule 310(b)(2).

38. The fact that an entity derives an economic benefit from another is not enough, on its own, to create a unitary business relationship such that apportionable income is derived from that relationship. *See ASARCO Inc. v. State Tax Comm'n*, 458 U.S. 307, 326 (1982); *F.W. Woolworth Co. v. Tax'n & Rev. Dep't*, 458 U.S. 354, 364 (1982).

ANSWER: Paragraph 38 contains a legal conclusion, not a material allegation of fact, and therefore does not require an answer pursuant to Rule 310(b)(2).

39. Passive investments which are held outside of a corporation's normal line of business are not unitary. *See Allied-Signal, Inc. v. Div. of Tax'n*, 504 U.S. 768, 788 (1992). (“[T]he mere fact that an intangible asset was acquired pursuant to a long-term corporate strategy of acquisitions and dispositions does not convert an otherwise passive investment into an integral operational one.”).

ANSWER: Paragraph 39 contains a legal conclusion, not a material allegation of fact, and therefore does not require an answer pursuant to Rule 310(b)(2).

40. Assets held as investments used for working capital can create unitary, apportionable income if they are used in business operations and serve an operational function. *Allied-Signal*, 504 U.S. 768, 787–88. The “operational function” test is not, however, an alternative means for finding a unitary business relationship. *MeadWestvaco Corp. v. Dep't of Rev.*, 553 U.S. 16, 29 (2008). When the asset in question is an investment in *another business* the unitary standards relating to functional integration, centralization of management, and economies of scale apply. *MeadWestvaco*, 533 U.S. at 30.

ANSWER: Paragraph 40 contains a legal conclusion, not a material allegation of fact, and therefore does not require an answer pursuant to Rule 310(b)(2).

41. A “corporation’s use of the funds not the mere availability of the funds is the guiding factor in determining whether the income sought to be apportioned has an operational or investment function.” *Home Interiors and Gifts, Inc. v. Dep’t of Rev.*, 741 N.E.2d 998, 1004 (Ill. App. 2000).

ANSWER: Paragraph 41 contains a legal conclusion, not a material allegation of fact, and therefore does not require an answer pursuant to Rule 310(b)(2).

42. Regulations issued by the Department state that, for items of interest, rent, capital gain, and dividends, if the item is related to or used in the corporation’s trade or business it can be considered business income for Illinois income tax purposes. 86 Ill. Admin. Code 100.1030(c)(2)–(5).

ANSWER: The Department assumes that “86 Ill. Admin. Code 100.1030(c)(2)–(5)” was intended to be “86 Ill. Admin. Code 100.3010(c)(2)–(5),” and on such basis admits the statements contained in Paragraph 42. The regulation speaks for itself.

43. Swagelok lacks functional integration, centralization of management, and economies of scale with McDonald Fund, the partnership in which it holds a passive 2.75% interest.

ANSWER: The Department lacks sufficient knowledge or information to form a belief as to the truth or falsity of the statements contained in Paragraph 43.

44. Because Swagelok is nonunitary with McDonald Fund, any income derived from the partnership is not apportionable under both the Due Process Clause and the Commerce Clause of the U.S. Constitution, and therefore cannot be business income for Illinois income tax purposes. *See* 35 ILCS 5/1501(a)(1).

ANSWER: The Department denies the statements contained in Paragraph 44.

45. Because the Portfolio Investments were not used in or related to Swagelok's trade or business, they are not business income pursuant to the Department's own Regulations. *See* 86 Ill. Admin. Code 100.1030(c)(2)-(5).

ANSWER: The Department assumes that "86 Ill. Admin. Code 100.1030(c)(2)-(5)" was intended to be "86 Ill. Admin. Code 100.3010(c)(2)-(5)," and on such basis denies the statements contained in Paragraph 45.

46. Interest income, rental income, capital gain income, and dividend income earned from Swagelok's passive investments were not wages, salaries, commissions, or any other form of remuneration paid to employees for personal services. Accordingly, such income is not "compensation" under Illinois law. *See* 35 ILCS 5/1501(a)(3).

ANSWER: The Department admits the statements contained in Paragraph 46.

47. Because the interest income, rental income, capital gain income, and dividend income earned from Swagelok's passive investments is neither business income nor compensation, it must be nonbusiness income, which is defined as "all income other than business income or compensation." 35 ILCS 5/1501(a)(13).

ANSWER: The Department denies the statements contained in Paragraph 47.

48. Interest income, rental income, capital gain income, and dividend income earned from Swagelok's passive investments was, accordingly, properly classified by Swagelok as nonbusiness income on its originally filed Illinois income tax returns, and the Department's assertions in its Notice of Deficiency are improper and lacking legal authority.

ANSWER: The Department denies the statements contained in Paragraph 48.

WHEREFORE, the Department prays that this Tribunal enter an Order that:

- a. denies each prayer for relief contained in Count II of the Taxpayer's Petition;
- b. finds the Notices of Deficiency are correct as issued;
- c. orders judgment in favor of the Department and against the Taxpayer; and
- d. grants any further relief this Tribunal deems just and appropriate.

COUNT III

Swagelok's Failure to Pay the Alleged Additional Tax was Due to Reasonable Cause

49. Swagelok incorporates by this reference and realleges paragraphs 1 through 48 as though fully-set forth herein.

ANSWER: The Department incorporates and repeats its answers to Paragraphs 1 through 48 as if fully set forth herein.

50. For the tax periods ending December 2006, December 2008, and December 2009, the Department imposed a late-payment penalty pursuant to Section 3-3(b-20)(2) of the Illinois Uniform Penalty and Interest Act ("UPIA").

ANSWER: The Department admits the statements contained in Paragraph 50.

51. Section 3-8 of the UPIA provides that penalties, other than a fraud penalty, "shall not apply if the taxpayer shows that his failure to . . . pay tax at the required time was due to reasonable cause." 35 ILCS 735/3-8.

ANSWER: Paragraph 51 contains a legal conclusion, not a material allegation of fact, and therefore does not require an answer pursuant to Rule 310(b)(2).

52. Swagelok made a good faith effort to determine the correct reporting of its income tax liability through the exercise of ordinary business care and prudence.

ANSWER: The Department lacks sufficient knowledge or information to form a belief as to the truth or falsity of the statements contained in Paragraph 52.

53. Swagelok therefore acted with reasonable cause and, under Section 3-8 of the UPIA, no penalties should apply to the audit deficiencies that the Department assessed against Swagelok.

ANSWER: Paragraph 53 contains a legal conclusion, not a material allegation of fact, and therefore does not require an answer pursuant to Rule 310(b)(2).

WHEREFORE, the Department prays that this Tribunal enter an Order that:

- a. denies each prayer for relief contained in Count III of the Taxpayer's Petition;
- b. finds the Notices of Deficiency are correct as issued;
- c. orders judgment in favor of the Department and against the Taxpayer; and
- d. grants any further relief this Tribunal deems just and appropriate.

Respectfully Submitted,

LISA MADIGAN
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State of Illinois

By: /s/ Ronald Forman
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ILLINOIS INDEPENDENT TAX TRIBUNAL
CHICAGO, ILLINOIS

SWAGELOK COMPANY,
Petitioner

v.

ILLINOIS DEPARTMENT OF REVENUE,
Respondent

15-TT-128

AFFIDAVIT OF CHARLES B. CLAY
PURSUANT TO TRIBUNAL RULE 5000.310(b)(3)

Under penalties as provided by Section 1-109 of the Code of Civil Procedure, 735 ILCS §5/1-109, I, Charles B. Clay, being first duly sworn on oath, depose, and state as follows:

1. I am currently employed by the Illinois Department of Revenue.
2. My current title is Revenue Auditor III.
3. I reviewed Swagelok Company's (the "Petitioner") Illinois income tax audit for the tax years ending December 31, 2006, December 31, 2007, December 31, 2008, and December 31, 2009.
4. I lack the requisite knowledge to either admit or deny the allegations alleged in the Petitioner's Petition, Paragraphs 20, 22, 27, 29, 30, 32, 43 and 52.
5. I am an adult resident of the State of Ohio and can truthfully and competently testify to the matters contained herein based upon my own personal knowledge.

Under penalties as provided by law pursuant to Section 1-109 of the Code of Civil Procedure, the undersigned certifies that the statements set forth in this instrument are true and correct, except as to matters therein stated to be on information and belief and as to such matters the undersigned certifies as aforesaid that he verily believes the same to be true.

Charles B. Clay
Charles B. Clay
Revenue Auditor III
Illinois Department of Revenue

Date: 7/22/2015