

IN THE ILLINOIS INDEPENDENT TAX TRIBUNAL

THE CHERNE COMPANY INC, )  
)  
Petitioner, )  
)  
v. )  
)  
THE ILLINOIS DEPARTMENT OF REVENUE, )  
)  
Defendant. )

No.

RECEIVED  
APR 28 2011  
BY: \_\_\_\_\_  
16TT80

**PETITION**

Petitioner, The Cherne Company, Inc., (“Petitioner”), by and through its attorneys, Horwood Marcus & Berk Chartered, complains of the Defendant, the Illinois Department of Revenue (“Department”), and alleges as follows:

**PARTIES**

1. Petitioner is a Minnesota holding company headquartered in 2010 at 9855 W 78th Street, Suite 400, Eden Prairie, Minnesota 55344.
2. Petitioner’s wholly owned operating subsidiary, Cherne Contracting Corporation, (“Petitioner Subsidiary”), is a Michigan corporation headquartered in 2010 at 9855 W 78th Street, Suite 400, Eden Prairie, Minnesota 55344. Petitioner Subsidiary filed for Dissolution with the State of Michigan on September 8, 2011.
3. Petitioner filed a 2010 Form 1120 ST (inclusive of Petitioner Subsidiary income) as a Subchapter S corporation.
4. Petitioner is represented by Horwood Marcus & Berk Chartered attorneys Fred O. Marcus and Jennifer A. Zimmerman located at 500 West Madison St., Suite 3700, Chicago, Illinois 60661, and can be reached at 312-606-3210 or fmarcus@hmblaw.com; and 312-606-3247 or jzimmerman@hmblaw.com, respectively.

5. Petitioner's FEIN is 38-1679618.
6. Petitioner's Illinois Account Number is 09805-39392.
7. The Department is an agency of the Executive Department of the State Government and is tasked with the enforcement and administration of Illinois tax laws. 20 ILCS 5/5-15.

**NOTICE**

8. The tax involved is the Illinois Personal Property Tax Replacement Income Tax ("Replacement Tax") imposed under the Illinois Income Tax Act (the "Act"), 35 ILCS §5/201, et seq.
9. On May 8, 2014, the Department issued to Petitioner a Notice of Proposed Deficiency ("Proposed Notice") in the total amount of \$526,130 consisting of tax in the amount of \$457,504 of tax and penalty in the amount of \$68,626 of penalty for Petitioner's 2010 tax year ("Year at Issue").
10. In its Proposed Notice, the Department sought to reclassify a gain of \$46,205,118 recognized by Petitioner on the sale of Petitioner Subsidiary's assets and \$11,118 of interest from allocable nonbusiness income to apportionable business income and include such gain in the Replacement Tax base without a corresponding adjustment to Petitioner's apportionment factor.
11. On July 3, 2014, the Petitioner timely filed a Request for Informal Conference Board Review with the Department's Informal Conference Board.
12. On December 4, 2015, the Informal Conference Board issued its Action Decision instructing the Department to complete its audit in accordance with the Proposed Notice.
13. On March 4, 2016, the Department issued to Petitioner a Notice of Deficiency in the amount of \$605,818.57 for the Year at Issue ("Notice").

14. A true and accurate copy of the Notice is attached hereto as Exhibit A.
15. This petition is being timely filed within sixty-days (60) of the Notice.

### **JURISDICTION**

16. Petitioner brings this action pursuant to the Illinois Independent Tax Tribunal Act (“Tribunal Act”), 35 ILCS 1010/1-1 to 35 ILCS 1010/1-100.
17. This Tribunal has jurisdiction over this matter pursuant to Sections 1-45 and 1-50 of the Tribunal Act because (i) the Department’s Notice seeks tax in excess of \$15,000 and (ii) Petitioner timely filed this petition within 60 days of the Notices.

### **BACKGROUND**

18. Petitioner Subsidiary was a heavy industrial contractor offering construction services in equipment, civil/structural, electrical, instrumentation and insulation work, in addition to core mechanical services on a nationwide basis.
19. In 2010, Petitioner Subsidiary sold its operations to Kiewit CH Co. (“Kiewit”) in a sale that was structured as an asset sale.
20. The sale included all of Petitioner Subsidiary’s assets and business operations including the corporate name, employees and existing contracts.
21. In exchange for its purchase of Petitioner Subsidiary’s assets and business, Kiewit CH paid cash in the amount of \$81,702,780 and assumed certain liabilities in the amount of \$10,695,948 for a total purchase price of \$92,398,728.
22. Petitioner Subsidiary incurred transaction costs in the amount of \$717,932 in connection with the sale.
23. Following the sale, the sales proceeds were distributed to Petitioner.
24. Petitioner filed for Dissolution with the State of Minnesota on July 1, 2015.

25. The sales agreement included an allocation of the sale proceeds to the various classes of asset in accordance with Section 1060 of the Internal Revenue Code as follows: purchased current assets - \$20,860,858, fair market value of tangible personal assets - \$3,023,364, and intangibles/goodwill of \$68,514,506.
26. During the Year at Issue, Petitioner and Petitioner Subsidiary were domiciled in Minnesota, but Petitioner Subsidiary was engaged in construction projects in Illinois and Missouri and had some of its tangible personal property deployed at the project sites in those two states.
27. On Petitioner's original 2010 return, the gain attributable to the tangible personal property was allocated to the state in which the assets were located as of the date of sale, and thus Petitioner's Illinois tax return allocated a portion of its gain to Illinois.
28. All tangible personal property not deployed at the projects was located at the corporate home office in Eden Prairie, Minnesota or equipment facility in Shakopee, Minnesota.
29. There was no taxable gain on the sale of current assets as the tax basis was equal to the purchase price allocation. The Petitioner recognized gain on the sale of its assets and business in the amount of \$69,460,281 of which \$23,255,163 was attributable to an irrevocable trust and an ESOP and \$46,205,118 was attributable to taxable shareholders.
30. A majority of the gain was attributable to goodwill and was therefore sourced to Minnesota, the location of the Petitioner's and Petitioner Subsidiary's legal and commercial domiciles.
31. A brief review of Petitioner's consolidated sales during tax years prior to the Year at Issue shows an accurate depiction of Petitioner's operations.
32. For example, for the 1994-1996, and 1999-2004 years, Petitioner had no Illinois sales.

33. During the 1998 and 2007 tax years, Petitioner's Illinois sales were less than 5% of its total sales.
34. On average, Petitioner's total Illinois sales over a period of 17 years (from 1994 to 2010) represented only 21.50% of its total sales, and Petitioner's total Illinois sales over a period of 10 years (from 2001 to 2010) represented only 27.22% of its total sales.
35. In 2010, Petitioner generated sales from construction operations totaling approximately \$77 million; of that amount, approximately \$52 million was from construction work on a single project in Illinois.
36. Petitioner generated income from operations in 2010 of approximately \$2.4 million, \$1.6 million of which was apportioned to Illinois.
37. The Department's tax assessment for the Year at Issue was calculated based on reclassifying the \$46,205,118 gain and \$11,188 interest from nonbusiness income to apportionable business income.
38. The Department subjected the gain and interest to apportionment using an apportionment percentage of 67.4128% which was nearly identical to the 67.2719% apportionment factor reported on the original return. No adjustment was made to the sales factor to reflect the inclusion of the \$46,216,306 income in the tax base.
39. As a result, the Department has apportioned the gain attributable to the sale of Petitioner's assets and business to Illinois using only revenues associated with its constructions projects leading to the apportionment of income to Illinois out of all appropriate proportion to the business conducted by Petitioner in the state.

## COUNT I

**Inclusion of the gain recognized on the sale of Petitioner's assets in the tax base without a corresponding adjustment to the single-factor sales apportionment formula results in a disproportionate allocation of the income to Illinois in violation of the Commerce of the U.S. Constitution**

40. Petitioner realleges and incorporates by this reference the allegations made in paragraphs 1 through 39.
41. In *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977), the U.S. Supreme Court held that a state tax will not withstand a Commerce Clause challenge if the tax is not fairly apportioned.
42. Fair apportionment necessitates a "rational relationship between the income attributed to the State and intrastate values of the enterprise." *Mobil Oil Corp. v. Commissioner of Taxes*, 445 U.S. 425, 436-37 (1990).
43. An apportionment method that fails by design to take into account the factors that generated the apportioned income is constitutionally flawed because there can never be a "rational relationship between the income attributed to the State and the intrastate values of the enterprise." *Id*
44. An apportionment formula is not valid when the income attributed to the State is out of all appropriate proportion to the business transacted in that State or has led to a grossly distorted result. *Moorman Manufacturing Co. v. Bair*, 437 U.S. 267 (1978), *Allied-Signal, Inc. v. Director, Division of Taxation*, 504 U.S. 768 (1992); *ASARCO Inc. v. Idaho State Tax Comm'n*, 458 U.S. 307, 330 (1982); *F.W. Woolworth Co. v. Taxation and Rev. Dep't*, 458 U.S. 354, 364 (1982); *Container Corp. of America v. Franchise Tax Bd.*, 463 U.S. 159 (1983); *Hans Rees' Sons, Inc. v. North Carolina*, 283 U.S. 123 (1931).

45. The question of “fair representation” of a method of sourcing income, whether in deciding between separate accounting and apportionment, or in this case how the apportionment calculations are determined, ultimately depends on whether the standard method required by the state taxing authority results in distortion when applied to the specific facts of a specific taxpayer.
46. In *Hans Rees’ Sons, Inc. v. North Carolina*, 283 U.S. 123 (1931), the United States Supreme Court ruled in favor of a business engaged in leather tanning and manufacturing operations in determining that North Carolina’s taxation of the business using direct allocation, while not superficially discriminatory, nonetheless “operated unreasonably and arbitrarily, in attributing to North Carolina a percentage of income out of all appropriate proportion to the business transacted” in the state.
47. The U.S. Supreme Court found 250% distortion unconstitutional where the taxpayer established that, in determining its total income attributed to North Carolina, its apportionment percentage was no more than 21.7% based upon separate accounting, rather than between 66% and 85% as determined by the state based solely upon a property-factor apportionment method.
48. The Court in *Hans Rees* reviewed several other notable cases, including *Underwood Typewriter Co. v. Chamberlain*, 254 U.S. 113 (1920), and *Bass, Ratcliffe & Gretton, Ltd. v. Commission*, 266 U.S. 271 (1924).
49. While the courts in *Underwood* and *Bass* affirmed the state’s apportionment of the respective taxpayer’s income, notably in the U.S. Supreme Court discussion of these cases was the fact that in each case the standard method of sourcing of income took into account factors that were considered at least superficially representative of the business operations.

50. In the current case, if the gain recognized on the sale of Petitioner's assets is considered apportionable business income, then the apportionment factors should be reflective of the income being subjected to apportionment, which includes the gain from the sale of the business.
51. The Department has apportioned the gain on the sale of virtually all of Petitioner's assets to Illinois using only the revenues associated with Petitioner's 2010 construction projects, but not including any adjustment to reflect the magnitude of the revenues associated with the transaction (i.e. the sale) that generated the \$46.2 million gain.
52. The inclusion of the gain recognized on the sale of Petitioner's assets and business in the apportionable tax base without a corresponding adjustment to the single-sales factor results in a 1330% increase in income apportioned to Illinois which is out of all appropriate proportion to the business conducted by Petitioner in the state and far in excess of the distortion established in *Hans Rees*.
53. As a result, if the gain recognized on the sale of Petitioner's assets is considered apportionable business income, then the apportionment factor must be adjusted to reflect the inclusion of the gain in the numerator and denominator of the apportionment factors.

**WHEREFORE**, Petitioner prays that this Tribunal enter an Order that:

- a. finds and declares that the Department's inclusion of the gain from the sale of Petitioner's assets in the tax base without a corresponding adjustment to the apportionment formula results in an allocation of income to the state out of all appropriate proportion to the business conducted in the state in violation of the Commerce Clause;

- b. finds and declares that the gain from the sale of Petitioner's assets and business must be included in the numerator and denominator of Petitioner's apportionment formula; and
- c. grants such further relief as this Tribunal deems appropriate under the circumstances.

## COUNT II

### Penalties should be abated based on reasonable cause

54. Petitioner realleges and incorporates by this reference the allegations made in paragraphs 1 through 53.
55. In its Notice, the Department assessed what appears to be late payment penalties.
56. Illinois law provides that late payment penalties shall not apply if a taxpayer shows that its failure to pay tax at the required time was due to reasonable cause. 35 ILCS 735-8.
57. The most important factor to be considered in making a determination to abate a penalty will be the extent to which the taxpayer made a good faith effort to determine its proper tax liability and to pay its proper tax liability in a timely fashion. 86 Ill. Admin. Code §700.400(b).
58. A taxpayer will be considered to have made a good faith effort to determine and pay its proper tax liability if it exercised ordinary business care and prudence in doing so. 86 Ill. Admin. Code §700.400(b).
59. Pursuant to 35 ILCS 735/3-8 and 86 ILAC 700.400, Petitioner is entitled to penalty abatement for reasonable cause.
60. The Illinois tax return for this year (and in prior years as well) was timely filed and payments accurately and timely made.

61. Petitioner consulted with third party tax advisers with respect to both federal and state tax issues.
62. Specifically, with respect to the return filed for the Year at Issue, the issue in this case was researched for Illinois and other states, and guidance was provided based on research conducted by the third party tax advisors on the state tax treatment of such transactions.
63. The conclusion that Illinois would consider the gain on this sale to be nonbusiness income was not made without consideration of Illinois court decisions that supported this conclusion.
64. Moreover, Petitioner's position that the gain was allocable nonbusiness income was not a position that was grounded in any perceived tax avoidance.
65. Petitioner was an S corporation and except for the approximately 33% of stock held by a non-taxable Employee Stock Ownership Trust, all the ownership of that S corporation was by shareholders that were Minnesota residents.
66. This issue, whether the gain should be treated as business income or nonbusiness income for Illinois purposes, ultimately affects the split of state income tax liability on the sale between Minnesota and other states.
67. An increase in Illinois income tax will have a dollar-for-dollar offset against the Minnesota tax liability of the S corporation's Minnesota resident shareholders.
68. An increase in Illinois income tax will not reduce the overall state income tax burden of these shareholders.
69. As a result, Petitioner's assessed penalties for the Year at Issue should be abated.

**WHEREFORE**, Petitioner prays that this Tribunal enter an Order that:

- a. finds and declares that the penalties should be abated based on reasonable cause;  
and
- b. grants such further relief as this Tribunal deems appropriate under the  
circumstances.

Respectfully submitted,

**The Cherne Company, Inc.,  
Petitioner**

By: \_\_\_\_\_

One of its Attorneys

Fred O. Marcus  
Jennifer A. Zimmerman  
**HORWOOD MARCUS & BERK CHARTERED**  
500 West Madison Street, Suite 3700  
Chicago, Illinois 60661  
(312) 606-3200

# EXHIBIT A

# Notice of Deficiency

for Form IL-1120-ST, Small Business Corporation Replacement Tax Return



March 4, 2016



Letter ID: CNXXX15X31X26X83

#BWNKMGV  
#CNXX X15X 31X2 6X83#  
CHERNE CONTRACTING CORP  
THE CHERNE COMPANY INC  
ATTN: ROBERT J KLEMENHAGEN  
PO BOX 975  
MINNEAPOLIS MN 55440-0975

Taxpayer ID: 38-1679618  
Audit ID: A943128576  
Reporting period: December 2010  
Total Deficiency: \$605,818.57  
Balance due: \$605,818.57

We have audited your account for the reporting period listed above. The attached statement explains the computation of your deficiency and the balance due. **Illinois law requires that we notify you of this deficiency and your rights.**

**If you agree to this deficiency**, pay the total balance due as soon as possible to minimize penalty and interest assessed. Make your check payable to the "Illinois Department of Revenue", write your taxpayer ID on your check, and mail a copy of this notice along with your payment.

**If you do not agree, you may contest this notice by following the instructions listed below.**

- **If the amount of this tax deficiency, exclusive of penalty and interest is more than \$15,000, or if no tax deficiency is assessed, but the total penalties and interest is more than \$15,000**, file a petition with the Illinois Independent Tax Tribunal within **60 days** of this notice. Your petition must be in accordance with the rules of practice and procedure provided by the Tribunal (35 ILCS 1010/1-1, *et seq.*).
- **In all other cases**, file a protest with us, the Illinois Department of Revenue, within **60 days** of the date of this notice. If you file a protest on time, we must reconsider the proposed deficiency, and if requested, grant you or your authorized representative and administrative hearing. An administrative hearing is a formal legal proceeding conducted pursuant to the rules adopted by the Department and is presided over by an administrative law judge. Submit your protest on Form EAR-14, Format for Filing a Protest for Income Tax, (available on our website at [tax.illinois.gov](http://tax.illinois.gov)). If we do not receive your protest within **60 days**, this deficiency will become final. A protest of this notice does not preserve your rights under any other notice.
- **In any case**, you may instead, under Sections 2a and 2a.1 of the State Officers and Employees Money Disposition Act (30 ILCS 230/2a, 230/2a.1), pay the total liability under protest using Form RR-374, Notice of Payment Under Protest (available on our website at [tax.illinois.gov](http://tax.illinois.gov)), and file a complaint with the circuit court for a review of our determination.

If you do not protest this notice or pay the assessment total in full, we may take collection action against you for the balance due which, may include levy of your wages and bank accounts, filing of a tax lien, or other action.

If you have questions, call us at the telephone number shown below.

Sincerely,

Constance Beard  
Director

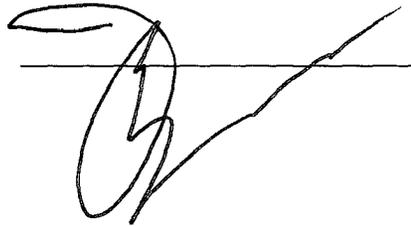
ILLINOIS DEPARTMENT OF REVENUE  
AUDIT BUREAU  
PO BOX 19012  
SPRINGFIELD IL 62794-9012

(217) 524-2230

**CERTIFICATE OF SERVICE**

Undersigned counsel of record hereby certifies that she caused a copy of the foregoing **The Cherne Company, Inc. Petition** to be served upon other counsel of record herein by electronic mail and by enclosing the same in an envelope, properly addressed, first-class postage prepaid and deposited in the US Mail at 500 West Madison Street, Chicago, Illinois, 60661, before the hour of 5:00 p.m. on the 28th day of April, 2016.

James R. Reynolds  
Illinois Department of Revenue  
100 W. Randolph St., 7-900  
Chicago, IL 60601  
James.R.Reynolds@Illinois.gov

A handwritten signature in black ink, appearing to be 'JR', written over a horizontal line.