ILLINOIS INDEPENDENT TAX TRIBUNAL

TYLER R. and TALBOT DEBUTTS CAIN,	)	
Petitioners,	)	
	)	
v.	)	No. 15-TT-63
	)	
THE ILLINOIS DEPARTMENT OF REVENUE,	)	
Respondent.	)	

DEPARTMENT'S RESPONSE TO
PETITIONERS' MOTION TO QUASH DISCOVERY

Respondent, the Illinois Department of Revenue (hereafter the "Department") by its attorney, Lisa Madigan, Attorney General of and for the State of Illinois, hereby responds in opposition to the Motion to Quash Discovery filed by Petitioners, Tyler R. Cain and Talbot Debutts Cain ("Petitioner").

Petitioner raises three arguments in support of his contention that Department's discovery requests should be Quashed; first, that Judicial Estoppel should be applied; second, that Collateral Estoppel should be applied; and third that the Department's discovery requests are irrelevant to the issue in this matter. In the alternative, Petitioner requests discovery "be limited to the subject of what changed" between January 1, 2005 and the 2007 date of the sale of the Abbott stock.

Department contends that neither Judicial Estoppel nor Collateral Estoppel applies to the current litigation. Department also asserts that its discovery requests are relevant to the Department's theory of this case – that TRC Trading Inc. is in fact an active, not passive, business, and that historically Petitioner has treated TRC Trading Inc. as an active business for both federal and state income tax purposes by deducting certain expenses not allowed for

passive investment entities, that TRC Trading Inc. continued to deduct expenses not allowed by passive entities for tax year 2007, and that Petitioner has not taken the necessary steps to change the character of TRC Trading Inc. to passive for the tax year ending December 31, 2007, by filing amended federal returns.

FACTS

The Prior Controversy: *Cain v. Hamer* – 1996 through 2004

Department audited Tyler and Talbot Cain (the "Cains" or "Petitioner") for the periods beginning January 1, 1996 through December 31, 2004. Department determined that the Cains were required to file Illinois individual income tax returns for the periods beginning January 1, 1996 through December 31, 2004 because the Cains were residents of the state of Illinois for those periods. On August 18, 2006, the Department issued a Notice of Deficiency ("2006 NOD") to the Cains pursuant to Section 902(c) of the Illinois Income Tax Act ("IITA"), assessing a total liability of $1,842,582.00 for the periods beginning January 1, 1996 through December 31, 2004. Exhibit 1, 2006 Notice of Deficiency. The 2006 NOD stated "We determined your correct Illinois income tax for the taxable years *** because you failed to file an income tax return as required by Illinois law. [IITA Section 201(a)]." Exhibit 1, pg. 2.

The Cains timely protested the Department's 2006 NOD by paying under protest $1,842,582.00 on October 4, 2006, filing a Complaint in the Circuit Court of Cook County on October 6, 2006 (docket number 2006-L-050986), and obtaining a preliminary injunction preventing the transfer of the funds from the protest fund on October 12, 2006, pursuant to the State Officers and Employees Money Disposition Act (30 ILCS 230/1 et seq.) (hereinafter referred to as the "Protest Monies Act"). In their Complaint, the Cains alleged that they were not residents of Illinois for 2006 NOD periods, and that applying Section 1501(a)(20) to Plaintiffs

violates the Equal Protection Clause, Uniformity Clause, and Due Process Clause of the U.S. Constitution and of the Illinois Constitution. Exhibit 2, Complaint in Cook County 2006-L-050986, Counts I and II. In litigating the 2006 NOD, the parties stipulated to certain facts, including:

> 1. The relevant tax periods are the years ending December 31, 1996 through December 31, 2004 (the "Relevant Period").
>
> ***
>
> 6. On December 10, 1990, Mr. Cain sold his seat at the CBOE for $205,000.
>
> ***
>
> 58. During the Relevant Period, Mr. Cain did not perform any personal services for TRC Trading, Inc.
>
> 59. TRC Trading, Inc., an S corporation under the federal Internal Revenue Code, had no paying clients at any time during the Relevant Period.
>
> 60. During the Relevant Period, TRC Trading, Inc. never offered or provided services to the public.
>
> 61. Mr. Cain never prepared the tax returns for TRC Trading, Inc.
>
> 62. The federal income tax returns for TRC Trading, Inc. during the Relevant Period contained the following deductions for salary and pension contributions to or on behalf of Mr. Cain:

Tax Year	**Salary**	**Pension Contribution**
1996	$60,000	$47,433

1997	$60,000	$56,473
1998	$60,000	$73,938
1999	$60,000	$72,378
2000	$60,000	$100,169
2001	$60,000	$118,008
2002	$60,000	$238,685
2003	$-0-	$322,451
2004	$-0-	$303,696

> 63. Mr. Jacobson, a certified public accountant, prepared tax returns for the various partnerships and companies owned by the Cains during the Relevant Period.
>
> 64. Mr. Jacobson recommended that Mr. Cain's pension plan be terminated in 2004 when he began preparing TRC Trading, Inc.'s tax returns, since there was no business activity taking place and there was no reason to have such liability. TRC Trading, Inc. did not file any amended federal income tax returns for any years in the Relevant Period.
>
> 65. During the Relevant Period, Mr. Cain made only a few trades (approximately ten or less) each year through TRC Trading, Inc.

Exhibit 3, Stipulation of Factual Matters, Cook County 2-L-050986.

On December 20, 2010, the Cains filed a Motion for Summary Judgment. Exhibit 4, Plaintiff's Brief in Support of their Motion for Summary Judgment ("Plaintiff's Brief"). In Plaintiff's Brief, the Cains argued that they were not residents of Illinois for the periods reflected in the 2006 NOD. *Id*. at 5 ("Under Illinois law residency is determined by an individual's intent."), 9 ("In 1995, the Cains intended to and did establish Florida as their permanent domicile

and abandoned Illinois as their permanent domicile, and, therefore, were not subject to the IITA."), 14 ("The Cains abandoned Illinois as their Domicile for Purposes of the IITA."), 17 ("A Homestead Exemption does not, as a matter of law, determine a taxpayer's state of residence for purposes of the IITA.").

In their Cross Motion for Summary Judgment, the Defendants argued only that the Cains were residents of Illinois because "[t]he Cains failed to demonstrate they have abandoned their [Illinois] Domicile." Exhibit 5, Defendants' Brief in Support of its Motion for Summary Judgment and in Opposition to Plaintiff's Motion for Summary Judgment ("Defendants' Brief"), pg. 11. In the Defendants' Brief, Defendants only briefly referenced TRC Trading, Inc., and only in support of Defendants' argument that the Cains' declarations of domicile should be given little weight. Department argued that the Declarations of Florida Domicile were inconsistent with tax documents the Cains signed under penalty of perjury and which resulted in reducing the Cains' tax liability for federal, state, and county tax purposes, and therefore, the declaration should be given little weight. Exhibit 5, Defendants' Brief, pg. 18 ("The problem is that the pension deductions by TRC Trading were improper because TRC Trading did not conduct or engage in any active trade or business nor did Tyler perform any personal services for it, generally the prerequisites for such deductions. See Treas Reg. § 1.404(a)-(1)(b); Temp-Reg § 1.162-10T, A-1. This fact is relevant only in response to the Cains' strong emphasis on their declarations under penalty of perjury on pages 10-12 of their Brief. The Cains put their credibility directly at issue by insisting that their sworn declarations of Florida domicile are entitled to great weight. Yet they claimed a Florida homestead exemption at the same time they were claiming an Illinois homestead exemption, and they also received the benefit of pension deduction on their personal income tax returns as well as the benefit of the contributions to Tyler's pension plan they were not

entitled to”).[1] The Defendants did not argue that the Department’s 2006 NOD should have been upheld based on TRC Trading, Inc.’s treatment of income as Illinois business income.

In Plaintiffs’ Reply Brief, the Cains did not address TRC Trading, Inc. Exhibit 6, Plaintiffs’ Reply Brief in Support of Their Motion for Summary Judgment and Against Defendants’ Motion for Summary Judgment.

The Circuit Court of Cook County stated in its Memorandum of Decision and Judgment that the issue in the case was: “Whether the Cains were residents of the State of Illinois for the taxable years of 1996 through 2004.” Exhibit 7, Memorandum of Decision and Judgment, 06-L-050986, August 26, 2011, pg. 9. The circuit court held, “the Cains were not residents of the State of Illinois for the Relevant Period.” Exhibit 7, pg. 15. The trial court decision did not mention TRC Trading, Inc. Exhibit 7.

On appeal, the First District Appellate Court of Illinois affirmed the trial court’s decision. *Cain v. Hamer*, 2012 IL App (1st) 112833. The appellate court held that the issue on appeal was “whether the plaintiffs qualified as Illinois residents during the relevant time period.” *Id*. at ¶1 (“On appeal, the parties dispute whether the plaintiffs qualified as Illinois residents during the relevant time period.”). The appellate court did not mention TRC Trading, Inc. in its decision. *Cain v. Hamer*, 2012 IL App (1st) 112833.

[1] In 1996 through 2004, TRC Trading Inc., an S corporation, reported Illinois business income on Form IL-1120S or IL-1120-ST. However, the Cains did not file Illinois individual income tax returns for 1996 through 2004 to report the Illinois-source income of TRC Trading, Inc. Additionally, TRC Trading, Inc. deducted a pension contribution in all years from 1996 through 2004 and deducted certain business expenses, both of which reduced TRC Trading, Inc.’s taxable income (payable by its sole shareholder, Tyler Cain). By filing federal returns reporting TRC Trading Inc’s active business income and deductions, but failing to report that business income to Illinois, the Cains received a tax windfall. Conversely, if TRC Trading Inc. did not conduct an active business, as the testimony of Tyler Cain and Robert Jacobson suggested, TRC Trading Inc. was not entitled to take the deductions for pension contributions and business expenses, and therefore, the Cains received the benefit of illegal deductions that reduced their individual income tax. Either way, the Cains received a windfall – either they were shorting Illinois, by failing to report Illinois-source income of TRC Trading Inc.’s active business, or they were shorting the IRS by claiming illegal deductions for the passive investment activities of TRC Trading Inc. Defendants pointed out this inconsistency, as well as the Cains’ inconsistent homestead exemptions, for the sole purpose of attacking the credibility of the Cains.

The Current Controversy: *Cain v. IDOR* – 2005 through 2007

On July 10, 2009, Department issued an Audit Initiation letter to Petitioners for the periods beginning January 1, 2005 through December 31, 2007. Exhibit 8, Notice of Audit Initiation. On June 23, 2008, TRC Trading Inc. filed a 2007 Form IL-1120ST reporting all its income as Illinois business income. Exhibit 9, 2007 Form IL-1120-ST of TRC Trading, Inc. On December 12, 2011, Department issued an Audit Expansion letter to Petitioners, which notified Petitioners that the audit was being expanded to include the period ending December 31, 2008. Exhibit 10, Notice of Audit Expansion. During the audit of Petitioners for the periods ending December 31, 2004, through December 31, 2007, TRC Trading, Inc. filed a 2007 IL-1120ST-X (amended return), which reported all its income as non-business income. The Department rejected TRC Trading, Inc.'s amended return because 1) the amended return was filed after the expiration of the statutory limitations period, 2) the Department determined that all income of TRC Trading, Inc. was business income, and 3) because, even assuming *arguendo* the income were non-business income, TRC Trading, Inc.'s return improperly reported deductions not allowed for passive entities. Department did not issue a notice to TRC Trading, Inc. because TRC Trading, Inc. did not request a refund or report an underpayment on the amended return. Nevertheless, TRC Trading, Inc.'s 2007 amended return was not accepted by the Department.

After conducting an audit of Petitioner for the tax years ending December 31, 2005, 2006, 2007, and 2008, the Department issued a Notice of Deficiency (hereafter "2015 Notice") to Petitioner on February 5, 2015 assessing $118,671.60 of taxes, interest, and penalties for the period ending December 31, 2007. Exhibit 11, 2015 Notice. The Department asserts that the income Petitioner received from TRC Trading, Inc. for the tax year ending December 31, 2007 is Illinois-source income pursuant to IITA Section 201(a). 35 ILCS 5/201(a); 35 ILCS 5/303(b)(3).

ARGUMENT

Judicial Estoppel Does Not Apply.

Taxpayer alleges that Judicial Estoppel precludes the Department from asserting its position – that TRC Trading, Inc.'s income is Illinois-source income – in support of its 2015 Notice. Petitioners' Motion to Quash Discovery, pg. 4.

The uniformly recognized purpose of the doctrine of judicial estoppel "is to protect the integrity of the judicial process by prohibiting parties from 'deliberately changing positions' according to the exigencies of the moment." *Seymour v. Collins*, 2015 IL 118432, ¶ 36, quoting *New Hampshire v. Maine*, 532 U.S. 742, 749–50 (2001).

The Illinois Supreme Court has identified five "prerequisites" as "generally required" before a court may invoke the doctrine of judicial estoppel: The party to be estopped must have (1) taken two positions, (2) that are factually inconsistent, (3) in separate judicial or quasi-judicial administrative proceedings, (4) intending for the trier of fact to accept the truth of the facts alleged, and (5) have succeeded in the first proceeding and received some benefit from it. *Seymour v. Collins*, 2015 IL 118432, ¶ 37 citing *People v. Runge*, 234 Ill.2d 68, 132 (2009); *People v. Jones*, 223 Ill.2d 569, 598, (2006), *People v. Caballero*, 206 Ill.2d 65, 80 (2002). "Judicial estoppel, like all estoppels, must be proved by clear and convincing evidence." *Seymour v. Collins*, 2015 IL 118432, ¶ 39.

The Illinois Supreme Court requires that all elements of judicial estoppel be established before a court considers applying the doctrine. *Seymour v. Collins*, 2015 IL 118432, ¶ 47. In *Seymour*, the Illinois Supreme Court held that:

> We note, even if all factors are found, intent to deceive or mislead is not necessarily present, as inadvertence or mistake may account for positions taken and facts asserted. Second, if <u>all</u> prerequisites

> have been established, the trial court must determine whether to apply judicial estoppel—an action requiring the exercise of discretion. Multiple factors may inform the court's decision, among them the significance or impact of the party's action in the first proceeding, and, as noted, whether there was an intent to deceive or mislead, as opposed to the prior position having been the result of inadvertence or mistake.

Seymour v. Collins, 2015 IL 118432, ¶ 47 (emphasis added). Thus, to succeed on a claim of judicial estoppel, the proponent must prove all five elements. *Seymour v. Collins*, 2015 IL 118432, ¶ 47.

Petitioner argues that the requirements for judicial estoppel "are not set in stone, however; instead the doctrine of judicial estoppel is "flexible and not reducible to a pat formula. . . . This is especially true when strict application of a requirement would frustrate the public policy underlying the application of the doctrine." Petitioners' Motion to Quash Discovery, pg. 4. Petitioners cite *Smeilis v. Lipkis*, (2012 IL App (1st) 103385, ¶ 46) for this proposition and point to *Moy v. Ng*, 371 Ill. App. 3d 957 (1st Dist. 2007), a case concerning breach of fiduciary duty by an attorney/escroee. *Moy* is factually distinguishable.

In *Moy*, the defendant had testified via affidavit before the ARDC that she had misappropriated client funds. Plaintiff attempted to use this prior testimony to prevent summary judgment to defendant based on the plaintiff's judicial admission in a Request to Admit. (Plaintiff failed to timely Answer defendant's Request to Admit facts, and therefore all facts therein were judicially admitted pursuant to Illinois Supreme Court Rule 216.) However, the court, envoking judicial estoppel, held that the defendant's sworn testimony in the ARDC affidavit prevented summary judgment to the defendant even though defendant did not "prevail" on the ARDC claim. The *Moy* court held that judicial estoppel barred the defendant from utilizing facts established by the plaintiffs' judicial admissions to prevail in the case because

"plaintiffs' judicial admissions were overborne by the defendant's admissions in the ARDC proceedings." *Moy*, 371 Ill. App. 3d at 963-64.

Moy is distinguishable from the case at bar because here the Department did not settle with the Cains in the prior litigation. Thus, the Department received no benefit from the court's ruling in *Cain v. Hamer* – not even something as small as preventing the need for motions for summary judgment. Rather, the Department lost the prior litigation and received no money from the protest fund. Therefore, the holding in *Moy* should not apply here.

Additionally, the Supreme Court has held that all judicial estoppel factors must be present when asserting a claim for judicial estoppel against the government. *Heckler v. Community Health Services of Crawford Cty., Inc*., 467 U.S. 51, 60 (1984) ("A private party cannot prevail in asserting judicial estoppel against the government without demonstrating that the traditional elements of an estoppel are present."). There is an important public policy to be served by this requirement. "When the Government is unable to enforce the law because the conduct of its agents has given rise to an estoppel, the interest of the citizenry as a whole in obedience to the rule of law is undermined. It is for this reason that it is well settled that the Government may not be estopped on the same terms as any other litigant." *Heckler v. Community Health Services of Crawford Cty., Inc.*, 467 U.S. 51, 60 (1984). Accordingly, "The party claiming the estoppel must have relied on its adversary's conduct in such a manner as to change his position for the worse." *Heckler v. Community Health Services of Crawford Cty., Inc*., 467 U.S. 51, 59 (1984). "[T]hat reliance must have been reasonable in that the party claiming the estoppel did not know nor should it have known that its adversary's conduct was misleading. *Id.* citing *Wilber National Bank v. United States*, 294 U.S. 120, 124–125 (1935).

Unlike *Moy*, the Petitioners are asserting judicial estoppel against the Department, an

agency of the State of Illinois. Pursuant to supreme court case law, the Petitioner's must prove every element of their judicial estoppel claim. Petitioners have admitted that the Department did not prevail in the prior proceeding of *Cain v. Hamer*, 2012 IL App (1st) 112833. Thus, the Petitioner cannot meet its burden to prove "all prerequisites" of judicial estoppel, and therefore, Petitioner's claim must fail.[2]

Collateral Estoppel Does Not Apply.

Petitioners' next argue that the Department should be collaterally estopped from asserting that the TRC Trading Inc. income is active business income. Petitioners' Motion to Quash Discovery, pg. 6. The requirements for application of collateral estoppel are: (1) the issue decided in the prior adjudication is identical to that presented in the current action; (2) the party against whom the estoppel is asserted was a party to or in privity with a party to the prior adjudication; and (3) the prior adjudication resulted in a final judgment on the merits. *Dowrick v. Village of Downers Grove*, 362 Ill.App.3d 512, 516 (2d. Dist. 2005); *Bagnola v. SmithKline Beecham Clinical Laboratories*, 333 Ill.App.3d 711, 723 (2d. Dist. 2002). However, Petitioners' fail to point out that Illinois follows the rule stated in section 22 of the Restatement (Second) of Judgments. That is:

> a defendant who may interpose a claim as a counterclaim, but fails to do so, is not thereby precluded from maintaining an action on that claim unless '[t]he relationship between the counterclaim and the plaintiff's claim is such that successful prosecution of the second action would nullify the initial judgment or would impair rights established in the initial action' . . . .

[2] See also *Astor Chauffeured Limousine Co. v. Runnfeldt Investment Corp.*, 910 F.2d 1540, 1547 (7th Cir.1990) ("The principle is that if you prevail in Suit # 1 by representing that A is true, you are stuck with A in all later litigation growing out of the same events." "Applying judicial estoppel only if a party *prevails* in Suit # 1 on the basis of a position inconsistent with that latterly taken allows alternative pleadings, and permits a party to change position to conform with the evidence. After losing Suit # 1 on Theory # 1, it may have learned a lesson about what the facts show and the law supports; an "inconsistent" position in Suit # 2 then may be closer to the truth. . . . The offense [against the judicial system] is not taking inconsistent positions so much as it is *winning*, twice, on the basis of incompatible positions." Internal citations omitted. Underlined emphasis added.)

Dowrick v. Village of Downers Grove, 362 Ill.App.3d 512, 517 (2d. Dist. 2005) quoting Restatement (Second) of Judgments §22(2)(b), at 185 (1982).

Department does not dispute that the Department was a party to the prior adjudication, or that the prior adjudication resulted in a final judgment on the merits. Rather, Department contends that the issue decided in the prior adjudication is not identical to that presented in the current action.

In *Cain v. Hamer*, Petitioners' herein were the plaintiffs who sued the Department and Treasurer, the defendants, under the Protest Monies Act, in protest of the 2006 NOD. Complaint, Counts I and II. The Cains asserted that they were non-residents of the state of Illinois and were therefore entitled to the money in the protest fund. Complaint, Counts I and II; Plaintiff's Brief in Support of their Motion for Summary Judgment. Department asserted that plaintiffs were residents of the State of Illinois and therefore the Department was entitled to the money in the protest fund. Defendants' Brief in Support of its Motion for Summary Judgment and in Opposition to Plaintiff's Motion for Summary Judgment. The Circuit Court of Cook County held that the issue in the case was: "Whether the Cains were residents of the State of Illinois for the taxable years of 1996 through 2004." Memorandum of Decision and Judgment, 06-L-050986, August 26, 2011, pg. 9. The circuit court held, "the Cains were not residents of the State of Illinois for the Relevant Period." Memorandum of Decision and Judgment, 06-L-050986, August 26, 2011, pg. 15. On appeal, the First District Appellate Court of Illinois affirmed the trial court's decision. *Cain v. Hamer*, 2012 IL App (1st) 112833. The appellate court held that the issue on appeal was "whether the plaintiffs qualified as Illinois residents during the relevant time period." *Id.* ¶1.

Contrary to Petitioners' assertions, the Department did not assert that TRC Trading Inc.

was a passive business and for this reason the Department was entitled to the money in the protest fund. Neither the Cains, nor the courts addressed the issue presented in the current action – whether the income of TRC Trading Inc. was Illinois-source income reportable on the Cains' 2007 Illinois individual income tax return.

The issue of Illinois business income is a mixed question of law and fact. *State, Dept. of Revenue v. OSG Bulk Ships, Inc., 961 P.2d 399, 409, FN 24 (Alaska 1998).* Where, as in *Cain v. Hamer*, facts are undisputed, whether a taxpayer's income is business income under the Illinois Income Tax Act is a question of law. *Kroger Co. v. Department of Revenue*, 284 Ill.App.3d 473, 482 (1st Dist. 1996). Because business income is a question of law when the facts are undisputed, the court in the prior adjudication would have had to make a ruling on business income if that issue were raised. (A finding that the Cains were not Illinois residents would not dispose of the issue of business income.) Thus, if the issue of TRC Trading, Inc.'s business/non-business income was not raised or decided in the prior litigation, then the Department cannot be foreclosed from asserting this position in support of a Notice of Deficiency for an entirely different period.

Additionally, successful prosecution of the Department's 2015 NOD would <u>not</u> nullify the judgment in *Cain v. Hamer*, nor would it impair rights established in the initial action. *Dowrick v. Village of Downers Grove*, 362 Ill.App.3d 512, 517 (2d. Dist. 2005); Restatement (Second) of Judgments §22(2)(b), at 185 (1982).

For these reasons, Collateral Estoppel does not apply to the facts in the current proceeding.

Department's Discovery Requests are Relevant to the Issues in this Case.

Next, Petitioner argues that the Department's discovery requests are "excessive, burdensome, and most unlikely to lead to the discovery of relevant information." Motion, pg. 12.

"It is well established that discovery is to be 'a mechanism for the ascertainment of truth, for the purpose of promoting either a fair settlement or a fair trial.' To this end, the object of all discovery procedures is disclosure, *** however, that right is limited to disclosure regarding matters relevant to the subject matter of the pending action. Nevertheless, great latitude is allowed in the scope of discovery." *Pemberton v. Tieman*, 117 Ill.App.3d 502, 504 (1st Dist. 1983) (Internal citations omitted). In Illinois, the concept of relevance for purposes of discovery is broader than for purposes of admitting evidence at trial. *Id*.; *Bauter v. Reding*, 68 Ill. App. 3d 171, 175 (3d. Dist. 1979). Relevance for discovery purposes includes not only what is admissible at trial, but also that which leads to admissible trial evidence. *TTX Co. v. Whitley*, 295 Ill. App. 3d 548, 556 (1st Dist. 1998); *Pemberton*, 117 Ill.App.3d at 505; *Crnkovich v. Almeida*, 261 Ill. App. 3d 997, 999 (3rd Dist. 1994); *United Nuclear Corp. v. Energy Conversion Devices, Inc.*, 110 Ill. App. 3d 88, 104 (1st Dist. 1982). Therefore, inquiries made under either Rule 213 or Rule 214 are permissible if they seek information that "may" lead to admissible evidence, as opposed to "must" lead to admissible evidence. *TTX Co. v. Whitley*, 295 Ill. App. 3d at 556. "Relevancy is determined by reference to the issues, for generally, something is relevant if it tends to prove or disprove something in issue." *Bauter v. Reding*, 68 Ill. App. 3d at 175.

Department contends that its discovery requests are relevant to the issues raised in the 2015 Notice and to Department's theory of this case. The 2015 Notice asserts that Petitioners owe Illinois Individual Income Tax because income from Petitioners' wholly owned S Corporation, TRC Trading, Inc., is Illinois-source business income. Petition, Exhibit B (Notice of Deficiency) and Exhibit C (Informal Conference Board, Action Decision) ("Tyler R. Cain's distribution from TRC Trading Inc. is business income and should be sourced to Illinois."). Petitioners assert that TRC Trading Inc. "had no trade or business" and therefore, had no

commercial domicile. Petition, ¶37, Counts I and II. Thus, the issue in this case is whether the gain realized by TRC Trading, Inc. on the sale of the Abbott stock is business income, and if so, whether Illinois is the commercial domicile of TRC Trading, Inc.

The parties agree that, during 2007, TRC Trading, Inc. sold stock in Abbott Laboratories. A gain on the sale of the Abbott stock was realized by TRC Trading, Inc. Section 303(b)(3) of the IITA provides: "Intangibles. Capital gains and losses from sales or exchanges of intangible personal property are allocable to this State if the taxpayer had its commercial domicile in this State at the time of such sale or exchange." Petitioners argue in their Petition that "TRC Trading, Inc. had a legal domicile in Illinois but no commercial domicile within the meaning of IITA section 1501(a)(2) and 86 Ill. Admin. Code§ 100.3210, and thus the capital gain [of TRC Trading, Inc.] could not be allocated to Illinois under IITA section 301(c)(2)(B)." Petition, ¶48. Income Tax Regulation 3210, defines "commercial domicile" as:

> the principal place from which the trade or business of the taxpayer is directed or managed. In general, this is the place at which the offices of the principal executives are located. Where executive authority is scattered, the place of daily operational decision making controls. Such determinations must be made on the basis of all the facts and circumstances.

86 Ill. Admin. Code § 100.3210(a).

In *Wheeling Steel Corp. v. Fox*, 298 U.S. 193 (1936), the landmark case concerning commercial domicile, the U.S. Supreme Court considered several factors in determining the commercial domicile of the taxpayer. The Court held that West Virginia was the commercial domicile of the taxpayer because the taxpayer had its "general business offices" in West Virginia, kept its books and accounting records in West Virginia, held meetings of its directors in West Virginia, accepted or rejected all contracts of sale and orders taken throughout the country

at the office in West Virginia, all invoices were payable in West Virginia, and West Virginia was where the officers conducted the affairs of the corporation. *Wheeling Steel Corp. v. Fox*, 298 U.S. 193, 211-12 (1936). The Court concluded from these facts that West Virginia was where "the management functioned," and, therefore, West Virginia was the commercial domicile. *Id*. at 212.

In *Associated Partnership I, Inc. v. Huddleston*, 889 S.W.2d 190 (Tenn. 1994), the Tennessee Supreme Court held that Tennessee was not the commercial domicile of the taxpayer where all management personnel resided outside of Tennessee, management meetings were held outside Tennessee, none of the directors or managing officers even traveled to Tennessee during the taxpayer's existence, the corporation's only officer in Tennessee had no duties, received no compensation from taxpayer, and was, in fact, a full-time employee of a subsidiary, the books of the taxpayer were maintained in New York, the corporate advisors - including lawyers, accountants, and investment bankers - were located in New York or London, and the taxpayer's most significant contact with Tennessee was the bank account maintained for the purpose of receiving partnership distributions. *Associated Partnership I, Inc. v. Huddleston*, 889 S.W.2d 190, 192-93 (Tenn. 1994). Tennessee and Illinois use the same definition of commercial domicile.

Since the Petitioners argue that TRC Trading, Inc. had no commercial domicile in Illinois, the factors discussed above are relevant to the Department's inquiry. Petition, Count I. Additionally, the activities conducted by TRC Trading, Inc. and its federal tax filings are relevant to the issue of business income. Department intends to show at trial that TRC Trading, Inc. is in fact an active, not passive, business, that historically Petitioner treated TRC Trading Inc. as an active business for both federal and state income tax purposes by deducting certain

expenses not allowed for passive investment entities, that TRC Trading Inc. continued to deduct expenses not allowed by passive entities for 2007, and that Petitioner has not taken the necessary steps to change the character of TRC Trading Inc. to passive for the tax year ending December 31, 2007 by filing federal amended returns.

Contrary to Petitioners' assertions, each tax year stands alone. *Fairview Haven v. Department of Revenue*, 153 Ill.App.3d 763, 775 (4th Dist. 1987) ("An adjudication of tax status in one year has no *res judicata* effect in a subsequent year. Thus, a taxpayer may be required to relitigate the issue of its entitlement to an exemption on an annual basis."); *Turn Verein Lincoln v. Paschen*, 20 Ill.2d 229, 230 (1960) ("The taxable status of the property for the years 1939 through 1952 was finally adjudicated by our decision in 8 Ill.2d 198. But because 'a cause of action for taxes for one year is not the same as or identical with a cause of action for taxes for subsequent years,' [] that decision is not *res judicata* as to the status of the property during the years 1953 through 1955."); P*eople ex rel. Tomlin v. Illinois State Bar Association*, 89 Ill.App.3d 1005, 1011-12 (4th Dist. 1980) (Even where the ownership and use of the property remain the same, a party may be required to relitigate the issue of its exemption annually.) Thus, the Department is entitled to investigate the facts concerning these issues – business income and commercial domicile – for the tax year 2007.

In addition to these issues, the Department plans to assert that the Duty of Consistency requires Petitioners to treat TRC Trading, Inc.'s gain as business income. The duty of consistency serves to prevent inequitable shifting of positions by taxpayers. *Janis v. Commissioner*, 461 F.3d 1080, 1085 (9th Cir. 2006). The elements for application of the duty of consistency are: "(1) a representation or report by the taxpayer; (2) on which the Commission has relied; and (3) an attempt by the taxpayer after the statute of limitations has run to change the

previous representation or to recharacterize the situation in such a way as to harm the Commissioner." *Kielmar v. C.I.R.*, 884 F.2d 959, 965 (7th Cir. 1989); *Herrington v. C.I.R.*, 854 F.2d 755, 758 (5th Cir. 1988). "If this test is met, the Commissioner may act as if the previous representation, on which he relied, continued to be true, even if it is not. The taxpayer is estopped to assert the contrary." *Estate of Ashman v. Comm'r*, 231 F.3d 541, 544 (9th Cir. 2000).

Based on the Duty of Consistency doctrine, the Department will argue that TRC Trading, Inc. has historically treated its income as business income, that it has received the benefit of business expense deductions and loss carryforwards, that the statute of limitations has expired for all years up to and including 2007, and therefore, the Department is prevented from recovering the tax due in prior years if TRC Trading, Inc. is found to be a passive investment business in 2007.

The discovery issued by the Department for tax years other than 2007 is relevant to the Duty of Consistency argument the Department intends to make. Therefore, discovery for years other than 2007 is relevant to the issues raised in the case.

Petitioners **also** argue the Department's discovery requests should be quashed to prevent "re-litigating issues which were recently decided" in *Cain v. Hamer*. **Motion, pg. 12.** However, Petitioners have not shown, and cannot show, that the issues raised in the 2015 NOD – Illinois-source income, commercial domicile and consistency of reporting – were "decided" by the courts in *Cain v. Hammer*. See *supra*, Judicial Estoppel Does Not Apply, pg. 7, Collateral Estoppel Does Not Apply, pg. 11.

Discovery Should Not Be Limited.

In the alternative, Petitioners argue that "discovery should be limited . . . to the subject of what changed, if anything between the time period beginning on January 1, 2005 (the first

day not covered by *Cain v. Hamer*) and the 2007 date of the sale of the Abbott stock." Motion, pg. 12. Petitioners assert that "the passive nature of TRC Trading, Inc.'s holdings was already established as of December 31, 2004." Motion, pg. 12.

Department denies that TRC Trading Inc.'s legal claim of solely passive activity was ever "established." First, none of the stipulations in *Cain v. Hamer* referred to by Petitioners use the word "passive." Second, neither the trial nor the appellate court held that TRC Trading, Inc. conducted only passive activities. Third, the stipulations do not establish that TRC Trading, Inc. conducted only "passive activity." Whether an entity is passive or active is a federal income tax concept, not an Illinois concept. 26 U.S.C. 469. "The term 'passive activity' means any activity - (A) which involves the conduct of any trade or business, and (B) in which the taxpayer does not materially participate." 26 U.S.C. 469(c)(1). "A taxpayer shall be treated as materially participating in an activity only if the taxpayer is involved in the operations of the activity on a basis which is regular, continuous and substantial." 26 U.S.C. 469(h)(1). TRC Trading, Inc. filed form U.S. 1120S reporting that TRC Trading, Inc. was an active trade or business for 2007. Exhibit 12, 2007 Form 1120S. That form shows that TRC Trading, Inc. treated its income as active business income and reported deductions that are not allowed for passive entities, including state, local, and foreign income taxes, and business expenses. See IRS Publication 925, Passive Activity and At-Risk Rules. Thus, whether TRC Trading, Inc. was an active or passive activity entity for 1996 through 2004 was not established in *Cain v. Hamer*, as there are no facts in the record to determine if Mr. Cain "materially participated" through "regular, continuous and substantial" activities.

Moreover, the activities of TRC Trading, Inc. have not been investigated. The Defendants' counsel discovered during the litigation of *Cain v. Hamer* that the Cains had

engaged in inconsistent reporting. Notably, that TRC Trading, Inc. filed as an active trade or business for federal income tax purposes but the Cains failed to file an Illinois non-resident return to report TRC Trading, Inc.'s Illinois-source business income. And if, as the Cains claimed, TRC Trading, Inc. was not an active trade or business, then it was not entitled to the deductions it took for business expenses and pension contributions from 1991 to 2004, and beyond. The Defendants in *Cain v. Hamer* pursued this issue only to the extent it showed inconsistencies and only for purposes of attacking the Cains' credibility. See *Supra*, pg. 4-5. Additionally, the depositions and Stipulation of Factual Matters suggest that only testimony was received on TRC Trading, Inc. No documents showing the activities of TRC Trading, Inc. were included in the deposition transcripts or the Stipulation of Factual Matters.

Finally, no facts have been discovered regarding TRC Trading, Inc.'s business activities or commercial domicile for 2007. The stipulations in *Cain v. Hamer* expressly relate to only the "Relevant Period" of December 31, 1996 through December 31, 2004. The auditor did not investigate the business income issue because the TRC Trading, Inc. amended return was filed after the statute of limitations expired. Instead, the auditor relied on TRC Trading, Inc.'s original IL-1120ST, which reported the gain as Illinois business income. Additionally, commercial domicile of TRC Trading, Inc. was not raised to the auditor.

For these reasons, discovery should not be limited "what changed" as many facts regarding business income and commercial domicile of TRC Trading, Inc. prior to January 1, 2005, were never investigated or established in the prior litigation of *Cain v. Hamer*, and these facts are at the heart of Department's Duty of Consistency argument.

CONCLUSION

The Petitioners', in their Motion to Quash, do not and cannot show that the elements

required to establish a claim for either judicial estoppel or collateral estoppel are met here.

The Petitioner's argument that the Department's discovery requests are "excessive, burdensome, and most unlikely to lead to the discovery of relevant information" is also unpersuasive. Motion, pg. 12. Petitioners argue the Department's discovery requests should be quashed to prevent "re-litigating issues which were recently decided" in *Cain v. Hamer*. However, Petitioners have not shown, and cannot show, that the issues raised in the 2015 NOD – Illinois-source income, commercial domicile and consistency of reporting – were "decided" by the courts in *Cain v. Hammer*. Instead, the Petitioners' ask this Tribunal to draw a conclusion – that TRC Trading, Inc.'s income was "passive" for 2007 – based on five stipulations from the prior litigation. Petitioner's reliance on the stipulations is misguided because the stipulations in *Cain v. Hamer* expressly relate only to the period beginning January 1, 1996 through December 31, 2004, and do not include the period at issue in the 2015 NOD. Additionally, stipulation paragraph 64 merely summarizes the opinion testimony of Mr. Jacobson, the Cains' accountant. Finally, not a single stipulation uses the word "passive." Nor do any of the stipulations state that the Cains did not "materially participate" in TRC Trading, Inc., which is the single element required of a passive activity business.

The Department's discovery requests have been carefully and thoughtfully crafted to elicit facts to show that during the relevant year at issue <u>in this case</u>, TRC Trading, Inc. was an active business with its commercial domicile in Illinois. As such, the income that TRC Trading, Inc. generated in 2007 was business income that must be sourced to the State of Illinois. Department has also included discovery requests relevant to its alternative theory – that the Duty of Consistency requires that TRC Trading, Inc.'s 2007 income be sourced to Illinois.

The Department merely desires the opportunity to gather all of the available facts in order to present them to this Tribunal for a decision on the merits.

WHEREFORE, Department prays this Tribunal deny Petitioners' Motion to Quash Discovery, order Petitioners to respond to Department's First Set of Interrogatives and First Request for Production of Documents within 14 days; and such further relief as this Tribunal deems just.

Respectfully Submitted,

LISA MADIGAN,
Attorney General, State of Illinois

By: _____

Special Assistant Attorney General

Rebecca Kulekowskis
Telephone: (312) 814-3318
Email: Rebecca.Kulekowskis@Illinois.gov

Jennifer Kieffer
Telephone: (312) 814-1533
Email: Jennifer.Kieffer@Illinois.gov

Special Assistant Attorneys General
Illinois Department of Revenue
Office of Legal Services
100 W. Randolph St., 7-900
Chicago, IL 60601

Facsimile: (312) 814-4344

DATED: December 8, 2015